

# Indiana Law Review



Volume 24 No. 4 1991

## SYMPOSIUM: 1990 AMERICAN AGRICULTURAL LAW ASSOCIATION ANNUAL CONFERENCE

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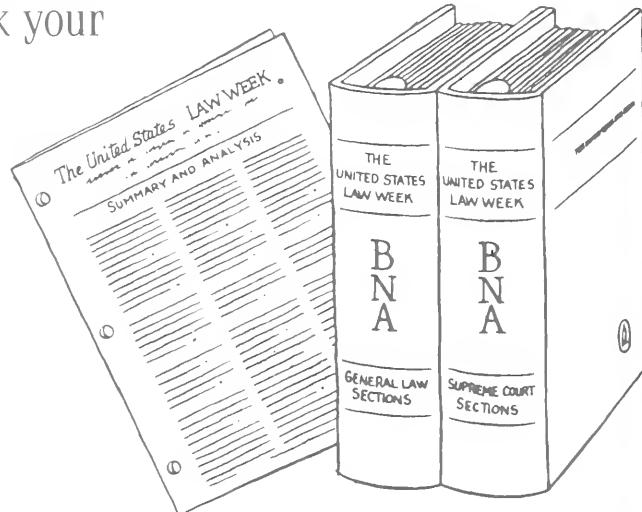
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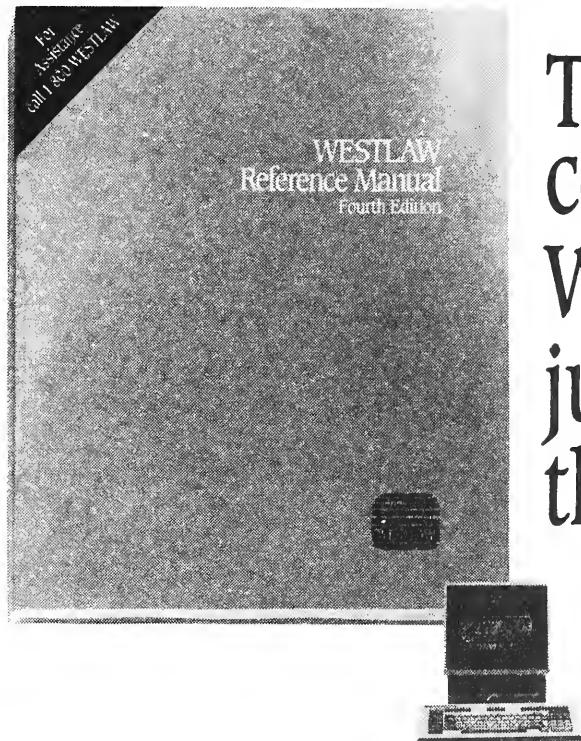
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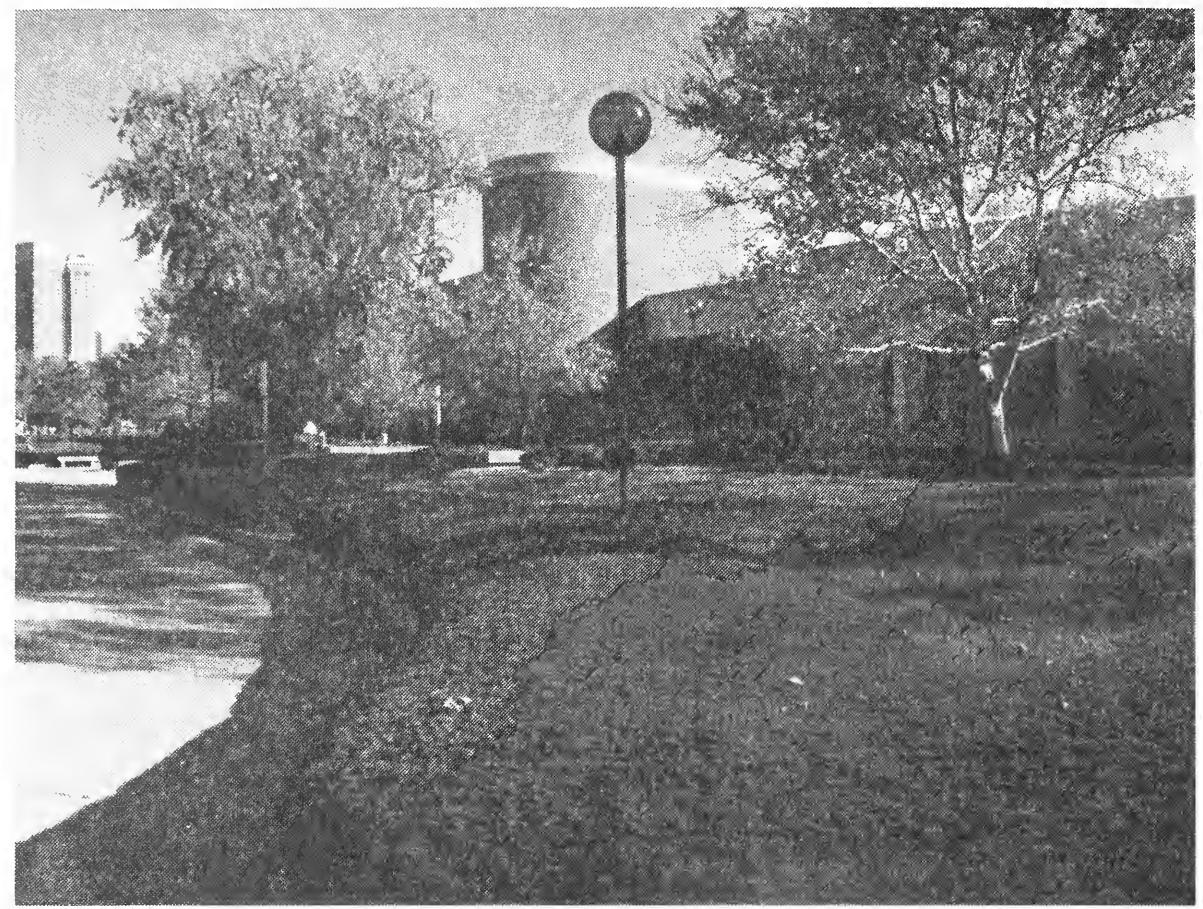
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## INTRODUCTION

The 1990 Annual Meeting and Educational Conference of the American Agricultural Law Association (AALA) marked the tenth anniversary of the founding of this organization. From its relatively small beginnings, AALA has developed into a thriving association with over 800 members. Practicing attorneys, law and agriculture professors, bankers, accountants, other professionals involved with agricultural law, and students make up the membership. AALA performs a crucial role in linking professionals in different disciplines through their common interest in agricultural law. The monthly newsletter, *Agricultural Law Update*, provides current information to members, and the Annual Meeting and Educational Conference offers two full days of high-level educational programming to members and others.

The 1990 Educational Conference, held in Minneapolis, Minnesota, focused on a number of current agricultural law issues, including business and estate planning, agricultural finance, land use, the environment, ethics, and international agricultural law developments. Forty-five speakers and moderators participated in the two-day program, which included both general and concurrent sessions. Speakers prepared outlines for an extensive Conference Handbook presented to each of the more than 200 persons attending the Conference.

Each year, articles by speakers at the Annual Meeting and Educational Conference are published as a law review symposium, which is sent to AALA members. AALA is honored that this year's articles are published in the *Indiana Law Review*. The Association is grateful for the helpful cooperation of the *Indiana Law Review* Board of Editors.

The subjects of the articles in this symposium come from two general areas. The first group of articles focuses on the business and financial aspects of the agricultural enterprise, and the second group deals with agricultural resources, particularly land. One additional article was contributed by the winner of the 1990 AALA student writing competition.

In an article entitled "Should the Unique Treatment of Agricultural Liens Continue?" Professor Keith G. Meyer reviews some of the issues connected with judicial, statutory, and consensual liens on personal

property. The existence of a variety of state agricultural liens and the lack of uniform rules for creation, perfection, and priority (especially in connection with state statutory liens) raise numerous problems. And, although Article 9 of the Uniform Commercial Code governs consensual liens (security interests), it does not govern all agricultural liens, nor does it resolve priority problems between UCC liens and numerous other liens. Professor Meyer offers solutions to the problems of conflicting liens, including the possible accommodation of these liens within an amended Article 9 of the UCC.

Also in connection with the financial aspects of agriculture, Susan A. Schneider's article, "Recent Developments in Chapter 12 Bankruptcy," analyzes 1990 appellate decisions on several controversial issues arising in Chapter 12 (family farm) bankruptcy litigation. Her article focuses on the issues of the appropriate interest rate under a confirmed plan; the treatment of a contract for a deed as a mortgage or executory contract; the interaction of the Agricultural Credit Act of 1987 and bankruptcy legislation; and livestock operations and the lien retention requirement for plan confirmation.

Those involved in agriculture are faced with a number of estate planning issues. Roger A. McEowen and Professor Neil E. Harl discuss long-term health care in their article, "Estate Planning for the Elderly and Disabled: Organizing the Estate to Qualify for Federal Medical Extended Care Assistance." The authors focus on the statutory requirements (particularly income and asset determinations) for Medicaid eligibility and related case law. In addition, they articulate estate planning techniques and considerations to mitigate the financial burden of long-term health care.

The crucial impact of federal tax law on the agricultural enterprise and the frequent changes in that law make issues of agricultural taxation particularly important. Professors C. Allen Bock and Philip E. Harris, assisted by John Deery-Schmitt, review significant new developments in their article, "Agricultural Taxation — Selected Issues." Among these developments are the potential tax traps involved in deferred payment grain sales; recent rules concerning depreciation; limitations on like-kind exchanges between related persons and deductions for term interests in property held by related persons; share leases and passive losses; and rent paid to a spouse.

Professor John D. Copeland provides an "Analysis of the Farmer's Comprehensive Liability Policy." After suggesting potential sources of liability and reviewing basic insurance law, Copeland discusses a number of common provisions of farmer's comprehensive liability policies and identifies problems arising from those provisions. He also focuses on some typical exclusions (for example, business pursuits and pollution) from the policies.

Federal farm subsidy payments are often crucial components of a farmer's income. On this subject, Alexander J. Pires, Jr. and Shelley L. Bagoly have contributed "Federal Court Jurisdiction Over USDA/ASCS Cases (How and in What Courts Farmers Can Seek Review of USDA Denials of Their Subsidy Payments)." After a summary of how USDA/ASCS subsidies are provided, the authors discuss the jurisdiction of the U.S. Claims Court and the U.S. District Court over farmers' cases seeking review of subsidy denials. Pires and Bagoly note that each venue presents difficulties for the farmer; the government often opposes District Court jurisdiction, and limited relief is available in Claims Court.

Two articles in this issue discuss agricultural and environmental resources, especially land resources. The first of these articles, by Anthony N. Turrini, focuses on the federal wetland conservation provisions of the Food Security Act of 1985. In "Swampbuster: A Report from the Front," Turrini describes the effect of the federal swampbuster law and regulations in the field during the first five years of applicability. He focuses on defects in the statute and on problems with implementation and enforcement of the swampbuster provisions. Some of the problems Turrini identifies have resulted in amendments to the swampbuster provisions in the Food, Agriculture, Conservation, and Trade Act of 1990.

In the second article, Professor Wim Brussaard presents an international viewpoint entitled "Protecting Agricultural Resources in Europe: A Report from the Netherlands." Western European countries have a limited amount of agricultural land; its use is subject to geographic restrictions, competing uses, and increasing concern for the environment. In the Netherlands a limited agricultural land area faces competition from conflicting interests. Brussaard analyzes the Dutch legal-administrative land-use structure, including physical planning, land development, and management agreements. He also addresses legal approaches to current problems, in particular European Community and Dutch set-aside regulations and Dutch manure legislation.

Several articles in this symposium focus on an issue of increasing importance and interest in some parts of the United States: public access to rural land for recreational access. A continuing growth in demand for outdoor recreation has not been matched by increased federal and state support for recreational areas and facilities. This offers an opportunity to private landowners who may be interested in alternative uses of their land. A number of legal issues, including questions of liability, confront these landowners.

Cynthia Boyer Blakeslee's article addresses "Legal Concerns Triggered by Alternative Land Use—Subtle Issues and Potential Traps." She highlights some of the interesting and unexpected consequences of a change in land use. Among the issues about which an attorney must provide advice are the effect of zoning ordinances and deed restrictions,

the status of preferential tax assessments, and the impact of environmental regulation. Other issues, too, are relevant to the landowner's decision.

In his article, Winston I. Smart presents an "Economic and Financial Analysis of Alternative Uses of Agricultural Land." He identifies and discusses the types of economic and financial issues that will affect the profitability and liquidity of alternative agricultural land use. In addition, he makes some general recommendations to help ensure the financial success of the alternative land use.

Professor John C. Becker analyzes the impact of state recreational use statutes in his article, "Landowner or Occupier Liability for Personal Injuries and Recreation Use Statutes: How Effective is the Protection?" These statutes encourage private landowners to open their land to the public for recreational purposes by limiting liability of the landowner or occupier under certain circumstances. Becker's article focuses on model recreation use acts, state statutory approaches, and court decisions involving the statutes. In addition, he discusses the effectiveness of these recreational use statutes in limiting liability.

Landowners who open their land to recreational use will normally require insurance coverage. Martha L. Noble discusses insurance in her article, "Recreational Access to Agricultural Land: Insurance Issues." After a brief overview of potential landowner liability, Noble addresses issues connected with the applicability of standard farmer's comprehensive liability insurance policies, other standard insurance policies, specialty insurance, and alternatives to landowner insurance coverage.

To give wider perspective to the issues involved in recreational use of agricultural land, Professor Helge Wulff has contributed "Recreational Access to Agricultural Land: The European Experience." Wulff surveys experience in Europe, where public access to the countryside is an important problem. Basing his analysis on laws in England and Wales, France, Norway, Sweden, and his native Denmark, he focuses on the law of public access to privately owned farmland, the liability of farmers and of persons entering farmland, and the various voluntary and compulsory means of providing access to the public. Though European legal systems differ from American, many of the practical problems of public access to the countryside are similar.

The final article in this symposium issue is the winning entry in the 1990 American Agricultural Law Association student writing competition. Each year, this competition is open to law students and other students interested in agricultural law, and the award-winning entrant receives a cash prize. The 1990 winner is Martin J. Troshynski, then a student at the University of Wyoming College of Law, who wrote on the subject of "Corporate Ownership Restrictions and the United States Constitution." Troshynski's article analyzes state statutory and constitutional restrictions on corporate ownership of farmland, in light of the Equal Protection and Commerce Clauses of the United States Constitution.

The American Agricultural Law Association is grateful to all the participants in the 1990 Annual Meeting and Educational Conference and especially to those who contributed articles to this symposium issue of the *Indiana Law Review*.

Margaret Rosso Grossman  
1991 President, AALA



# Indiana Law Review

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## ARTICLES

### Should the Unique Treatment of Agricultural Liens Continue?

KEITH G. MEYER\*

#### INTRODUCTION

Most states have a plethora of agricultural liens which protect unpaid creditors in varying degrees.<sup>1</sup> Typically, state legislatures have created statutory liens to give special protection to certain people and economic groups involved in the production or financing of agricultural products. Most of these statutory liens were created in the 1930s or 1980s, when the agricultural economy was severely depressed. Examples of those receiving special protection include: Those making special contributions to the value of the asset to which the lien attaches; unpaid agricultural product sellers and others who cannot be expected to comply with Article 9 of the Uniform Commercial Code (UCC);<sup>2</sup> and groups that might be subordinated to prior perfected secured creditors.

There is neither intrastate nor interstate uniformity with regard to statutory agricultural liens. Such liens vary with respect to how the lien

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\* E.S. and Tom W. Hampton Professor of Law, University of Kansas. B.A., Cornell College, 1964; J.D., University of Iowa, 1967. Copyright © by Keith G. Meyer, all rights reserved.

Professor Meyer wishes to thank the University of Kansas School of Law's Postlethwaite Fund for its support and Derek I. Grimes for his fine research assistance.

1. For example, California has at least 14. See CAL. CIV. CODE §§ 3051-52, 3061 (West 1974 & Supp. 1991) (veterinary and thresher); CAL. FOOD & AGRIC. CODE §§ 3062-64 (West 1986 & Supp. 1991). Florida has 14. See, e.g., FLA. STAT. ANN. §§ 83.10-19 (West 1987) (landlord); *id.* § 534.54 (West 1988) (seller of hogs or cattle). Illinois has 11. See, e.g., ILL. ANN. STAT. ch. 26, para. 9-104 (Smith-Hurd 1974 & Supp. 1990) (landlord).

2. See U.C.C. §§ 9-203(4), 9-303 (1989). The citations in this Article are to the 1989 version of the Uniform Commercial Code unless otherwise indicated. The source is SELECTED COMMERCIAL STATUTES (West 1990).

is created, perfected, and enforced. Likewise, they vary with respect to the priority of the statutory lienholder vis-a-vis other creditors and purchasers of the good subject to the lien. Moreover, they are not found in one place in the statutes nor are they cross referenced in Article 9. Some agricultural liens are common-law liens. Although liens give the creditor rights in specific property of the debtor that are equivalent to those of a secured party, Article 9 normally is inapplicable.

The economic difficulties of the late 1970s and 1980s produced record numbers of conflicts between creditors and between farmers and creditors.<sup>3</sup> During this period, the use of archaic statutory liens increased dramatically, and state legislatures promulgated new ones.<sup>4</sup> Secured creditors who diligently complied with Article 9 were not as protected as they thought. Many were junior to liens that, in many instances, were not recorded. Often the legal system does not provide any clear, easily discoverable rules governing competing claims to agricultural collateral upon the default of the debtor when one of the claimants has a lien not covered by Article 9. This is true whether questions of priority arise in state court or in a bankruptcy proceeding.

Article 9 provides relatively simple, clear rules for resolving disputes between lien creditors and secured creditors and between two secured creditors. However, with the exception of those limited possessory liens covered by section 9-310, Article 9 does not apply to conflicts involving nonpossessory liens. State law concerning statutory liens is difficult to understand and to ascertain.<sup>5</sup> The situation regarding bankruptcy is basically the same. Sections 506 and 544 of the Bankruptcy Code make clear that the rules in Article 9 govern priority questions covered by Article 9. On the other hand, statutory liens are treated differently. For

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3. Priority issues arose both in and out of bankruptcy. Priority battles in bankruptcy will almost always involve different questions because of the trustee's avoidance powers under sections such as 11 U.S.C. §§ 544, 545, 547, 551 (1989).

4. Many sellers of essential inputs such as fertilizer, seed, and chemicals got into the credit business but did not try to comply with Article 9. Consequently, many relied on statutory liens or wanted the UCC changed to protect them because normally, if they complied with Article 9, they would not have priority due to the first to file rule of § 9-312(5). *See infra* text accompanying note 153.

5. *See* State Survey and Rapid Finder Chart prepared by the Subcommittee on Agriculture and Agribusiness Financing, Commercial Financial Services Committee, Section of Business Law of the American Bar Association. This report is available through Steven Turner, partner at Baird, Holm, McEachen, Pedersen, Hamann & Strasheim, in Omaha, Nebraska, and will appear in the *Oklahoma Law Review*. *See also* Dainow, *Vicious Circles in the Louisiana Law of Privileges*, 25 LA. L. REV. 1 (1964); Dieball, *Addressing Priority Disputes Between a Statutory Landlord's Lien and an Article Nine Security Interest in Texas*, 31 S. TEX. L.J. 191 (1990); Saxowsky, Fagerlund & Priebe, *Modernizing Agricultural Statutory Liens After the Federal "Clear Title" Law — the North Dakota Experience*, 11 J. AGRIC. TAX'N & L. 30 (1989).

example, landlord liens are avoidable by a bankruptcy trustee under section 545.<sup>6</sup> Other statutory liens that are not perfected or enforceable against a bona fide purchaser on the date of bankruptcy can be avoided under section 545(2). However, whether a lien is perfected or whether a bona fide purchaser takes free of the lien is determined by state law. Results are not easily predictable because Article 9 does not apply. No uniform rule exists for perfection or for determining who wins as between a lien holder and other creditors or purchasers of goods subject to statutory liens.

Agricultural credit has other problems. Congress became involved in secured financing by enacting a poorly drafted and unclear federal farm products rule that applies to the sale of farm products subject to an Article 9 security interest but not to statutory liens.<sup>7</sup> Many producers complain that Article 9's first to file priority rule is unfair. They argue that if a farmer gave a perfected security interest in all then-owned crops and livestock and all after-acquired crops and livestock and then defaulted, the farmer could not obtain financing from anyone else for a new crop because the first lender would not subordinate and would not finance again unless the old debt was retired.<sup>8</sup>

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6. 11 U.S.C. § 545 (1988) provides in part: "The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien . . . (3) is for rent; or (4) is a lien for distress for rent." *See, e.g., In re Waldo*, 70 Bankr. 16 (Bankr. N.D. Iowa 1986).

In many states the landlord lien is considered to have priority over a perfected secured creditor. *E.g., Meyer v. Hawkeye Bank & Trust Co.*, 423 N.W.2d 186 (Iowa 1988); *Perkins v. Farmers Trust & Savings Bank*, 421 N.W.2d 533 (Iowa 1988). The trustee might use § 551 to try to defeat the secured creditor to the extent of the landlord's lien priority over the secured creditor. 11 U.S.C. § 551 (1988) provides: "Any transfer avoided under section . . . 545 . . . is preserved for the benefit of the estate but only with respect to property of the estate." This is also the case in Minnesota. "A perfected landlord lien has priority over all other liens or security interests in crops grown or produced on the property that was leased and the crop products and proceeds." The trustee can probably use § 551 to defeat the secured creditor to the extent of the landlord lien's priority in that state. MINN. STAT. ANN. § 514.960 (West 1990).

7. 7 U.S.C. § 1631 (1989). *See infra* note 64.

8. *See U.C.C. §§ 9-203-04, 9-312(5).* Section 9-312(2) often did not help because the debt was not in arrears for longer than six months. For cases dealing with § 9-312(2), see, *e.g., In re Cress*, 89 Bankr. 163 (Bankr. D. Kan. 1988), in which the court held that because Farmers Home Administration (hereinafter FmHA) could have declared the whole debt due for failure to pay an installment, the debt was considered overdue when the installment was missed. *But see United States v. Minster Farmers Co-operative Exchange, Inc.*, 430 F. Supp. 566 (N.D. Ohio 1977); *In re Smith*, 82 Bankr. 62 (S.D. Ill. 1988). *In re Connor*, 733 F.2d 523 (8th Cir. 1984) (debtor's obligation was less than six months overdue and other installments not due) was distinguished. *See also In re Rogers*, 39 Bankr. 295 (Bankr. W.D. Ky. 1984); *McCoy v. Steffen*, 227 Neb. 27, 416 N.W.2d 16 (1987). Section 9-312(2) is the subject of Nickles, *Setting Farmers Free: Righting the Unintended*

These events, among others, raised many questions about how the legal system was dealing with agricultural liens, whether it was causing the UCC to be a nonuniform code regarding agriculture, and how these events were affecting the availability of credit to agriculture. This Article will examine some of these issues, and concludes with some suggestions on how Article 9 can be changed to better address these problems.

## I. BACKGROUND

No uniform definition of "lien" exists. Liens give a person who has provided goods or services on credit an interest in specific property to assure payment for the goods or services. A lien on specific property may be obtained in a variety of ways.

Generally, there are three categories of liens: judicial liens, statutory liens, and consensual liens. Liens can exist in either real estate or personal property. Only personal property liens will be covered in this Article.

Judicial liens normally are created in the litigation process when the creditor seeks a money judgment on an unpaid debt and then enforces the judgment by properly taking control of nonexempt property.<sup>9</sup>

Statutory liens are not consensual and do not depend upon judicial action by the creditor. They are status liens that arise by operation of law because of a particular creditor's status. The statutory lien gives the creditor an interest in specific goods to assure payment for goods, services, land, labor, or whatever was provided by the person entitled to the lien. Statutory lien holders are, in effect, given the rights of a secured creditor even though they did not bargain for security. Finally, these liens normally are given to creditors who sell goods on credit or who perform a service or otherwise give value that preserves or enhances the value of the property subject to the lien.<sup>10</sup>

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*Anomaly of UCC Section 9-312(2)*, 71 MINN. L. REV. 1135 (1987).

A secured party has no obligation to file a termination statement if there is outstanding debt. U.C.C. § 9-404(1).

9. Each state's enforcement mechanism and exemptions differ. Once the judgment is satisfied by seizure of specific personal property, the creditor is a lien creditor under Article 9. U.C.C. § 9-301(3).

10. Liens given for the sale of goods or the performance of services relating to the good to which the lien attaches are similar to purchase money security interests. Article 9 deals with purchase money security interests in the financing of the purchase of a good. U.C.C. § 9-107 defines purchase money security interests for Article 9:

A security interest is a "purchase money security interest" to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Consensual liens are obtained pursuant to an agreement and are covered by Article 9 of the UCC. It must be noted that under Article 9, the term "lien" is used as a contradiction to a security interest that is considered to be a consensual interest, as opposed to a lien that is not created by contract.<sup>11</sup>

Although three categories of liens are recognized, lawyers and judges often refer to liens in a generic fashion, rather than making clear what type of lien exists. It is important to note that liens are defined differently in different contexts. For example, under the Bankruptcy Code, a "'[l]ien' means charge against or interest in property to secure payment of a debt or performance of an obligation."<sup>12</sup> The Bankruptcy Code defines the three specific types of liens. A judicial lien is a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."<sup>13</sup> A statutory lien is a

lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.<sup>14</sup>

A "security interest" in the Bankruptcy Code is a "lien created by an agreement."<sup>15</sup>

Article 9, adopted in some form in all fifty states, controls consensual liens but it does not use the term "lien." Rather, "security interest" is the key concept. "'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation."<sup>16</sup> Security interests are voluntary consensual interests that arise pursuant to an agreement between a creditor and a debtor. These are the only types of interests in personal property that Article 9 authorizes.

Federal and state statutory liens exist with their own unique requirements for creation, perfection, and enforcement. Each state has agricultural liens that tend to reflect that state's struggle with bad economic times in the agricultural community. Agricultural liens normally are not found in just one section of a state statutory system, are not cross referenced in Article 9, and have no uniform requirements regarding

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11. 1 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 307-08 (1965).

12. 11 U.S.C. § 101(33) (1989).

13. *Id.* § 101(32).

14. *Id.* § 101(49).

15. *Id.* § 101(47).

16. U.C.C. § 1-201(37).

creation, perfection, enforcement, or priority. In addition, common law liens create the same detection and priority problems.<sup>17</sup>

#### *A. Conflicting Claims to Personal Property — Article 9 of the UCC*

In general, disputes concerning claims to personal property are governed by Article 9 of the UCC. However, most agricultural liens are not covered by Article 9. Section 9-102<sup>18</sup> declares that Article 9 applies to all *transactions*<sup>19</sup> regardless of form, *intended by the parties* to create a security interest in personal property. In other words, it applies to all contracts or agreements intended to create a security interest, and by negative implication does not apply to nonconsensual interests created in personal property.

Sections 9-102(2) and 9-104 exclude certain types of transactions. The last sentence of section 9-102(2) states: "This Article does not apply to statutory liens except as provided in Section 9-310."<sup>20</sup> Apparently, this sentence was added to make clear that security interests could not be considered statutory liens for bankruptcy purposes, and thus not subject to avoidance by the trustee under section 67(c) of the old Bankruptcy Act.<sup>21</sup> This is no longer a justification for this provision in view of the Bankruptcy Code definitions making clear that statutory liens and security interests are separate and distinct.<sup>22</sup> Also, section 9-104(b) excludes landlords' liens from coverage,<sup>23</sup> and section 9-104(c) provides that Article 9

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17. Common-law liens exist in many states and sometimes are combined with statutory provisions. *See, e.g.*, *In re Stookey Holsteins, Inc.*, 112 Bankr. 942 (Bankr. N.D. Ind. 1990) (common-law artisan's lien in frozen cattle embryos).

18. Section 9-102(1) states: "Except as otherwise provided in Section 9-104 on excluded transactions, this Article applies (a) to any transactions (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts . . . ." U.C.C. § 9-102(1) (1987).

19. These transactions must be consensual in nature, and all contracts and agreements are covered regardless of form. These agreements need not be in writing if the secured party has possession of the property. U.C.C. § 9-203(1)(a) (1987). Section 1-201(3) of the U.C.C. defines "agreement."

Also note that the new version of § 1-201(37) defines in more detail than in the previous uniform version when a document entitled a lease is really a security interest and the transaction is covered by Article 9. Remember that if a transaction is covered by Article 9 all rules (attachment, perfection, priority, and default) apply.

20. U.C.C. § 9-102(2).

21. *See* 1 GILMORE, *supra* note 11, at 306-08.

22. *See supra* text accompanying notes 9-16.

23. Professor Gilmore in this treatise indicated that landlord liens were excluded for two reasons. First, Article 9 is designed to apply only to consensual security interests. 1 GILMORE, *supra* note 11, at 313. Second, the landlord's lien does not create an interest in personal property. *Id.* Yet, it should be noted that in many states a landlord's lien for

does not apply "to a lien given by statute or other rule of law for services or materials except as provided in Section 9-310 on priority of such liens."<sup>24</sup> An explanation of this treatment is found in Comment 3 to section 9-104, which provides in part:

In all jurisdictions liens are given suppliers of many types of services and materials either by statute or by common law. It was thought to be both inappropriate and unnecessary for this Article to attempt a general codification of that lien structure which is in considerable part determined by local conditions and which is removed from ordinary commercial financing.<sup>25</sup>

Even though recognizing that state lien law was not uniform and that there was a need for a uniform law on liens for services and materials, the drafters of the UCC refused to develop a uniform lien scheme or to incorporate one into Article 9's coverage, with the exception of possessory liens covered under section 9-310.<sup>26</sup> Currently, nonArticle 9 liens play a significant role in agriculture financing.<sup>27</sup> However, section 9-310 is currently the only section that covers liens. Section 9-310 provides:

When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.<sup>28</sup>

Liens are either possessory or nonpossessory. Section 9-310 only applies to possessory liens. The creditor claiming the protection of section 9-310 must have possession of the good whose value has been enhanced or preserved by services or materials supplied by the creditor, and a statutory or common law lien must exist. In the only situation to which Article 9 applies, a qualified possessory lienholder defeats a prior perfected

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unpaid rent of farm land attaches to crops produced on the rented land when rent is not paid. *E.g.*, KAN. STAT. ANN. § 58-2524 (1983). Crops are clearly considered personal property under Article 9. U.C.C. §§ 9-105(1)(h), 9-203, 9-402(1), official comment 1.

24. U.C.C. § 9-104(c).

25. *Id.* § 9-104 official comment 3.

26. 1 GILMORE, *supra* note 11, at 306.

27. Unsecured lending and landlord liens play a significant role in agriculture today. More than 40% of land farmed today is leased; fertilizer, seed, feed, chemical, and petroleum suppliers sell supplies on open account relying on statutory liens if the purchaser does not pay. *See Bailey, Where Farmers Borrow*, 61 BANKING 75 (Mar. 1969).

Some states (for example, Kansas, Iowa, and Minnesota) have created special statutes dealing with suppliers of agricultural inputs.

28. U.C.C. § 9-310.

secured creditor. This priority rule is very similar to the super-priority given to purchase money security interest under section 9-312(4).<sup>29</sup>

Interestingly, the drafters of the UCC did not define the elusive concept of possession. While some sections indicate that the drafters did not intend to limit possession to physical possession,<sup>30</sup> common-law and nonUCC statutes of a particular state law play a large part in defining possession.<sup>31</sup> Courts recognize and distinguish actual possession, constructive possession, and custody, and thereby indicate that an owner may relinquish physical custody but retain legal possession.<sup>32</sup>

Occasionally, possession has not been limited to physical possession under state statutory liens requiring possession. For example, in *Henkel v. Pontiac Farmers Grain Co.*,<sup>33</sup> a thresher's statutory lien continued notwithstanding the thresher-lienor's surrendering physical possession. Other courts have construed the possession requirement narrowly. In *Northeast Kansas Produce Credit Association v. Ferbrache*,<sup>34</sup> the court, noting that secret liens are disfavored, held that the statutory veterinarian's lien requiring possession could be enforced only if the veterinarian had

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29. U.C.C. § 9-312(4) states:

A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.

This rule is an exception to the first to file rule, which normally determines priority under Article 9 when there is a conflict between two perfected secured creditors. See U.C.C. § 9-312(5)(a). It must be noted that § 9-310 does not require any public notice. Apparently, the drafters believed that possession was the only public notice that was required. This is consistent with the way Article 9 treats perfection; possession by the creditor of a good can amount to perfection under § 9-305 so long as attachment has occurred under §§ 9-203 and 9-303(1). Remember § 9-203 requires that there be an agreement between creditor and debtor, and it need not be in writing if the creditor has possession. U.C.C. §§ 9-203(1), 1-201(3).

30. See, e.g., U.C.C. § 9-305 official comments.

31. U.C.C. § 1-103 states:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

32. E.g., *Jacobson v. Aetna Casualty & Surety Co.*, 233 Minn. 383, 46 N.W.2d 868 (Minn. 1959). See also *In re Klipfer*, 62 Bankr. 290 (Bankr. S.D. Ohio 1986); *In re Roberts*, 37 U.C.C. Rep. Serv. (Callaghan) ¶ 1721 (Bankr. D. Kan. 1984). *Contra In re Walkington*, 62 Bankr. 989 (Bankr. W.D. Mich. 1986) (severed crops are not farm products). See generally *Baird & Jackson, Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983).

33. 55 Ill. App. 3d 898, 13 Ill. Dec. 635, 371 N.E.2d 352 (1977).

34. 236 Kan. 491, 693 P.2d 1152 (1985).

physical possession of the treated animals.<sup>35</sup> An interesting question is whether section 9-310's possession requirement would be controlled by a state court's interpretation of the relevant state lien's possession requirement. Because possession is not defined in the UCC, the state court's interpretation of the relevant law creating the lien arguably should control unless the conclusion is totally inconsistent with the section 9-310 possession requirement.

However, it is not clear why the possession requirement was included, and whether it was designed to provide some kind of public notice. Apparently, the drafters were attempting to preserve the priority that had been given by common law or by state statute to people such as warehousemen, garagemen, and inn keepers who had liens premised upon *physical possession* of the good.<sup>36</sup> It is also unclear whether the UCC drafters intended to exclude lien holders who were expressly given statutory liens under state law if they filed public notice of the lien. Moreover, it is not clear whether the priority was to be continued for lien holders who did not have possession, but who were given priority either by statute or court construction under preUCC law.

Section 9-310 does not cover many types of agricultural liens. Those that are covered include garageman,<sup>37</sup> warehouseman,<sup>38</sup> agister,<sup>39</sup> or feeder liens.<sup>40</sup>

#### *B. Judicial Liens and Article 9*

Lien creditors attempting to enforce a judgment against personal property are covered by Article 9. Section 9-201 provides: "Except as otherwise provided by this Act a security interest is effective according to its terms between the parties, against purchasers of the collateral and against creditors."<sup>41</sup> The definition of creditor includes lien creditors<sup>42</sup> whose priority is determined by section 9-301. This section provides: "A 'lien creditor' means a creditor who has acquired a lien on the property involved by attachment, levy or the like . . . and a trustee in bankruptcy from the date of the filing of the petition or a receiver in equity from

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35. *Id.*

36. 1 GILMORE, *supra* note 11, at 887-89.

37. *E.g.*, COLO. REV. STAT. § 38-20-106 (1990); FLA. STAT. ANN. §§ 713.50, .56, .73, .76 (West 1988 & Supp. 1990); KAN. STAT. ANN. § 58-201 (Supp. 1990).

38. *E.g.*, U.C.C. § 7-209.

39. *E.g.*, COLO. REV. STAT. §§ 38-20-102 to -103; 38-20-107 to -116 (1990); KAN. STAT. ANN. § 58-220 (1983).

40. *E.g.*, IOWA CODE ANN. §§ 579.1 to .3 (West 1950); KAN. STAT. ANN. § 58-220 (1983).

41. U.C.C. § 9-201.

42. U.C.C. § 1-201(12).

the time of appointment.”<sup>43</sup> Section 9-301 also deals with priority conflicts between unperfected secured creditors, lien creditors, and other third parties. Section 9-301(1)(b) states: “[A]n unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected.”<sup>44</sup> Thus, a lien creditor<sup>45</sup> defeats an unperfected secured creditor. On the other hand, a perfected secured creditor defeats a lien creditor.

### *C. Conflicts Between a Perfected Secured Party and Lien Holders Not Covered by Sections 9-310 or 9-301*

Agricultural liens not covered by the UCC are numerous and not uniform between the states or within one state. Examples include liens for stud service, for a commission merchant selling farm products, for a livestock feeder or stable keeper, for shoeing animals, for unpaid pasture rent, for unpaid rent of crop land (landlord lien), for veterinarian services, for labor and machines used to harvest farm products, for processing farm products, for production of supplies such as feed, fertilizer, seed and chemicals, and for bovine brucellosis treatment. Most of these liens are statutory and differ in substance, creation, perfection, enforcement, and priority relative to other creditors, or purchasers of farm products that might be subject to a statutory lien. No model or uniform lien laws exist, and it is often not clear how the lien is created, enforced, or what priority it is to receive. It is also difficult to determine what liens exist. These uncertainties cause a variety of problems. Creditors, and lawyers advising them, have no firm basis for making decisions. Both state and federal courts, particularly bankruptcy courts, have had difficulties resolving priority disputes involving agricultural liens. Agricultural liens present a number of bankruptcy issues.

## II. AGRICULTURAL LIENS AND BANKRUPTCY

Agricultural liens can be attacked by a trustee under at least three sections: 544(a), 545, and 547. Under section 544(a)(1), the trustee becomes a hypothetical lien creditor; the trustee is empowered to avoid any transfer<sup>46</sup> that, under nonbankruptcy law, is voidable by a creditor who

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43. U.C.C. § 9-301(3). A creditor who files a civil action seeking payment of an unpaid debt obtains a judgment and writ of execution, and a public official who seizes specific property becomes a lien creditor. In short, a general creditor does not become a lien creditor until it has control of specific property. *Id.*

44. *Id.* § 9-301(1)(b).

45. Remember that a trustee in bankruptcy is also a lien creditor. U.C.C. § 9-301(3).

46. Obtaining any interest in property of the debtor in any manner whether voluntary or involuntary is a transfer for purposes of the bankruptcy code. 11 U.S.C. § 101(50) (1990).

extended credit and obtained a lien on a debtor's property at the time the bankruptcy petition is filed. In other words, a trustee has the invalidation powers of a creditor who obtained an enforceable judicial lien against all of the debtor's property, irrespective of whether such creditor exists. This is the so-called "strong arm" clause. Conflicts between a trustee and creditors having Article 9 security interests will be determined by Article 9. Unperfected secured creditors will lose to a trustee under sections 9-301(1)(b) and 544(a)(1),<sup>47</sup> whereas a perfected security interest is not vulnerable under these sections. Section 544(a)(1) also applies to statutory liens and other nonconsensual liens such as judicial liens. This means that an unperfected statutory lien can be avoided.<sup>48</sup> Whether a statutory lien is perfected is determined by state law.<sup>49</sup> State law also determines whether the trustee as a hypothetical lien creditor can defeat a perfected statutory lien holder or another lien creditor that existed prior to bankruptcy.<sup>50</sup> In short, whether the trustee can prevail under section 544(a) is determined by state law.<sup>51</sup> Although it is beyond the scope of this Article, it must be noted that section 544(a)(3) gives a trustee the rights of a hypothetical bona fide purchaser of real estate from the debtor. Specifically, section 544(a)(3) empowers the trustee to invalidate a transfer of real estate which, under nonbankruptcy law, is voidable as to a bona fide purchaser of real estate, whether or not such a creditor actually exists.<sup>52</sup> This is similar to the bona fide purchaser avoidance power the trustee can use to attack statutory liens under section 545(2).

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47. See U.C.C. § 9-301(1)(b) and comment 2. Remember that the trustee is a lien creditor under § 9-301(3). The effect of § 9-301(1)(b) and § 544(a)(1) is to make an unperfected security interest unenforceable in bankruptcy. Perfected secured creditors cannot be affected by § 544(a)(1).

48. E.g., *In re Nicholson*, 57 Bankr. 672 (Bankr. D. Nev. 1986) (unperfected statutory attorney's lien avoidable under § 544(a)(1)).

49. *Id.*

50. A creditor who has become a lien creditor by obtaining an interest in specific property of the debtor within 90 days of bankruptcy will be subject to attack by the trustee under 11 U.S.C. § 547(b). If the creditor is considered an insider (see 11 U.S.C. § 101(30) (1988)), the trustee could avoid a lien that arose within one year of bankruptcy. 11 U.S.C. § 547(b)(4) (1988).

51. *Nicholson*, 57 Bankr. at 676 (1986).

52. The following hypothetical illustrates the application of § 544(a)(3). On January 1st, X borrows \$20,000 from S & L, and X gives S & L a real estate mortgage covering Greenacre. On March 1st, X files a bankruptcy petition. S & L did not record its mortgage. X's trustee can invalidate S & L's mortgage under § 544(a)(3) because normally, under state law, for a mortgagee to be protected against bona fide purchasers the mortgage must be recorded in the appropriate public office. The trustee is simply given the rights of a bona fide purchaser, and because a bona fide purchaser would prevail against S & L, the trustee will also prevail. See, e.g., *McCannon v. Marston*, 679 F.2d 13 (3d Cir. 1982); *In re Great Plains Western Ranch Co.*, 38 Bankr. 899 (Bankr. C.D. Calif. 1984); *In re Euro-Swiss Intern. Corp.*, 33 Bankr. 872 (Bankr. S.D.N.Y. 1983).

### A. *Statutory Liens*

Section 545 governs avoidance of statutory liens.<sup>53</sup> Under this section, a trustee can avoid a statutory lien on property of the debtor in a number of situations. Under section 545(1), a lien that becomes effective upon the filing of a bankruptcy petition or when the debtor becomes insolvent is avoidable. Pursuant to section 545(2), statutory liens that are "not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case may be avoided, regardless of whether such a purchaser exists."<sup>54</sup> Finally, statutory liens for rent or liens for distress are unenforceable.<sup>55</sup> Accordingly, many agricultural statutory liens are avoidable in bankruptcy.

### B. *Landlord Liens*

Landlord liens for unpaid rent are avoidable in bankruptcy.<sup>56</sup> Unique questions arise concerning landlord liens. Under a Minnesota statute, a person or entity that leases agricultural land "has a lien for unpaid rent on the crops produced on the property in the crop year and on the crop products and their proceeds."<sup>57</sup> The lien is perfected by filing a lien statement with the appropriate office under UCC section 9-401 within thirty days after the *crops become growing crops*.<sup>58</sup> Even if the landlord

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53. 11 U.S.C. § 545 (1988) states:

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien —

(1) first becomes effective against the debtor—  
(A) when a case under this title concerning the debtor is commenced;  
(B) when an insolvency proceeding other than under this title concerning the debtor is commenced;  
(C) when a custodian is appointed or authorized to take or takes possession;  
(D) when the debtor becomes insolvent;  
(E) when the debtor's financial condition fails to meet a specified standard; or  
(F) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien;

(2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists;

(3) is for rent;  
(4) is a lien of distress for rent.

54. *Id.*

55. 11 U.S.C. § 545(3), (4) (1989).

56. *See, e.g., In re Waldo*, 70 Bankr. 16 (Bankr. N.D. Iowa 1986).

57. MINN. STAT. ANN. § 514.960 (West 1990).

58. *Id.*

lien is perfected, it can be avoided in bankruptcy under section 545(3), which does not make reference to perfection, unlike section 545(2). Thus, perfection under state law is irrelevant. In such cases, it is a statutory involuntary lien and would be covered by section 545(3). Yet, section 546 limits the avoidance powers of the trustee under a number of sections, including section 545. Section 546(b) recognizes any state law grace period for perfection. Thus, if under state law a statutory lien still may be perfected at the time the bankruptcy is filed, and that perfection relates back to a prebankruptcy date, the lien will be considered perfected on the date the petition is filed. For example, in Minnesota if a bankruptcy occurred the day crops were planted, it appears that the landlord has thirty days to perfect. When a landlord perfects, the lien would be considered perfected on the date the bankruptcy petition was filed. However, this should not affect the trustee's ability to avoid landlord liens. Again, section 545(3) makes no reference to perfection, and it appears that section 546(b) was designed to protect creditors when the trustee was utilizing the other avoidance powers such as under sections 544, 547, and 545(2), in which perfection is a key question. This is not the case for landlord liens. Perfected or not, a landlord's lien is avoidable in all cases.<sup>59</sup>

In many states, the landlord lien has priority over a perfected secured creditor.<sup>60</sup> In these cases, a trustee can use section 551 to defeat the perfected secured creditor to the extent of the landlord's lien priority over the secured creditor. Section 551 provides: "Any transfer avoided under . . . 545 . . . is preserved for the benefit of the estate but only with respect to property of the estate."<sup>61</sup>

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59. E.g., *In re Coal-X Ltd.*, "76", 103 Bankr. 276 (Bankr. C.D. Utah 1986).

60. Some landlord lien statutes specifically provide that the landlord's lien has priority over a prior perfected security interest. E.g., MINN. STAT. ANN. § 514.960 (West 1990) states: "A perfected landlord lien has priority over all other liens or security interests in crops grown or produced on the property that was leased and the crop products and proceeds." Courts also reach this result. E.g., *Meyer v. Hawkeye Bank & Trust Co.*, 423 N.W.2d 186 (Iowa 1988); *Perkins v. Farmers Trust & Savings Bank*, 421 N.W.2d 533 (Iowa 1988). See also Note, *Priorities Between Article Nine Security Interests and Statutory Liens in Iowa*, 23 DRAKE L. REV. 169 (1973); *Dwyer v. Cooksville*, 117 Ill. App. 3d 1001, 454 N.E.2d 357 (1983). In Nebraska, an unpaid landlord apparently will lose to a prior perfected secured creditor. *McCoy v. Steffen*, 227 Neb. 72, 416 N.W.2d 16 (1987).

If custom farming or what some call "sharecropping" is involved, there can be no landlord lien because the owner of the land owns all of the crop. See *In re Hilligoss*, 849 F.2d 280 (7th Cir. 1988).

Remember that Article 9 does not apply to a landlord's lien because such a lien is not consensual, and § 9-104(b) excludes landlord liens. Thus, priority battles between landlord liens and other interests, such as perfected security interests, are determined by rules not found in Article 9. For a discussion of Illinois law, see *Shockley, Illinois' Farm Landlord's Lien—Is It Time for a Change?*, ILL. B.J. 864 (1989).

61. E.g., *In re Coal-X Ltd.*, "76", 103 Bankr. 276.

Much agricultural land is rented for cash. A variety of cash leases exist, but the most typical is a straight cash lease in which the rent is either a fixed price per acre or a fixed amount for the entire piece of land, payable in installments or in a lump sum.<sup>62</sup> Many cash leases are oral, and the only possible protection for nonpayment is the landlord lien. From a planning or advising perspective, these landowners with a straight cash lease either must get the money up front *or* obtain a perfected security interest<sup>63</sup> to be protected in the event the tenant files bankruptcy. However, even though a perfected security interest in the crops being produced on the rented land will be enforceable in bankruptcy, problems may still exist for the land owner.

For example, the priority rules of Article 9 may cause problems for the unsuspecting. Under section 9-312(5)(a), the first to file will prevail. This can be a problem for a landlord who obtains a security interest for the first time from a tenant who has been farming the ground for some time. If the tenant has signed a security agreement with a crop lender that includes an after-acquired property clause which grants a security interest in future crops to be grown on the land involved, the landlord will lose to the prior *perfected* crop lender. The priority of the first secured party dates from the filing of the financing statement. With a properly drafted security agreement containing a future advances clause and an after-acquired property clause, a secured creditor who files first will have priority if timely continuations of the financing statement are filed. Consequently, unless the landlord-tenant relationship is just beginning or new land is being added that the tenant previously has not farmed, the landlord is given only limited protection by the creation of an Article 9 security interest. Of course, a subordination agreement under section 9-316 may be sought from a prior secured party.

Another potential problem arises when the tenant sells the crop and the landowner is not paid. In order to enforce its security interest against the purchaser of the crop, the land owner *must* establish compliance with

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62. Flexible cash leases occur when the amount of cash rent varies according to production conditions and/or crop prices. Hybrid cash leases have some elements similar to those found in crop-share leases. Examples include the cash value of a certain number of bushels, and the tenant or guaranteed bushel leases in which the tenant agrees to deliver a specified amount of a certain type of grain to the landowner by a certain date.

63. The landowner will have to have a tenant sign a properly drafted security agreement. *See U.C.C. §§ 9-203(1), 9-204 (1987).* While an Article 9 security interest can be created in the lease form, it may be better to have two documents because the inclusion of all necessary Article 9 provisions may cause the lease to be too long. A landowner must also file an appropriate UCC-1 form. Of course, a security interest cannot be created if an oral lease is involved and no written security agreement is signed. *See Meyer, Should a Farm Lease Include an Article 9 Security Interest, 5 J. TAX'N & LAW 60-69 (1983).*

the notice requirements of the federal farm products rule of 7 U.S.C. § 1631.<sup>64</sup>

### C. Crop-Share Leases

Typically, landlord liens are not relevant to crop-share leases that usually require the rent be paid in proportion to the crops produced on the land, and the landlord normally pays part of the production expenses such as seed, fertilizer, and other chemicals. The recent bankruptcy case, *In re Norton*,<sup>65</sup> raises serious questions about how crop-share leases will be treated in bankruptcy. In *Norton*, the court held that the crop-share landlord who had paid half of the seed, lime, fertilizer, and other inputs and was to receive half of the crop produced on the rented land was only entitled to rent for the number of days that a Chapter 7 trustee had possession of the land.<sup>66</sup> The landowner's half of the bean crop totaled \$2165, but he was allowed only \$462. The court focused on the impact of Bankruptcy Code section 365.<sup>67</sup> However, the court's decision seems to have been premised on its conclusion that, under Illinois law, growing crops are treated as part of the realty until severed.<sup>68</sup> Consequently, because the tenant possessed the land until bankruptcy, the landowner had no ownership rights in the growing crops.<sup>69</sup> The court relied upon a 1962 case that predates the UCC, and concluded that the tenant had title to the whole crop until the lessor's share is severed.<sup>70</sup> The court did not focus on Article 9 or on the fact that the Illinois legislature enacted statutes in 1988 making clear that a real estate mortgagee and a receiver take subject to a perfected security interest in growing crops.<sup>71</sup>

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64. 7 U.S.C. § 1631 (1988). See, e.g., Kershen and Hardin, *Congress Takes Exception to the Farm Products Exception of the UCC: Centralized and Presale Notification Systems*, 36 U. KAN. L. REV. 383 (1988); Kershen and Hardin, *Congress Takes Exception to the Farm Products Exception of the UCC: Retroactivity and Preemption*, 36 U. KAN. L. REV. 1 (1987); Meyer, *Congress's Amendment to the U.C.C.: The Farm Products Rule Change*, 55 J. KAN. B. 17 (Sept./Oct. 1986). See also Meyer, *Litigation Under the Federal Farm Products Rule*, 12 J. AGRIC. TAX'N & LAW 373 (Winter 1991).

If no bankruptcy is involved, a statutory lien (landlord lien) prevails against purchasers in some states.

65. 112 Bankr. 932 (Bankr. C.D. Ill. 1990).

66. *Id.* at 936.

67. For a thorough discussion of farm leases and bankruptcy, see Grossman & Fischer, *The Farm Lease in Bankruptcy: A Comprehensive Analysis*, 59 NOTRE DAME L. REV. 598 (1984).

68. *Norton*, 112 Bankr. at 935-36. However, the court stated that the question of whether the crops were personalty or realty was "irrelevant." *Id.* at 935.

69. *Id.*

70. *Id.*

71. ILL. ANN. STAT. ch. 5, ¶ 2501-04 (Smith-Hurd Supp. 1990); *id.* ch. 110, ¶ 15-1702(f). See also *United States v. Newcomb*, 682 F.2d 758 (8th Cir. 1982).

Clearly, Article 9 applies to growing crops because they are considered goods,<sup>72</sup> and any attempt to obtain a security interest in them must comply with Article 9 attachment and perfection requirements.<sup>73</sup> Any real estate creditor who fails to comply will lose to a perfected secured party. The *Norton* court suggested that the only way the crop-share landlord can be protected in bankruptcy is to obtain a perfected security interest.<sup>74</sup> Thus, the court seemed to recognize that growing crops are personal property, and it must have assumed that the tenant had all of the rights in the crops. This conclusion is erroneous. If the tenant had rights in all crops being produced on the rented land, the tenant could give its lender a security interest in all of the crops. This is incorrect. The tenant only has the rights that he or she is entitled to under the lease, which in *Norton* was fifty percent. To create a security interest, the debtor must have rights in the collateral, and the tenant clearly did not have rights in all of the crops. The concept of rights is not defined in the UCC; thus, common law and other sections of the UCC become relevant.<sup>75</sup>

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72. U.C.C. §§ 9-105(1)(h), 9-203(1), 9-402(1) and comment 1 (1987).

73. *Id.* §§ 9-203-04, 9-303, 9-401-02.

74. *Norton*, 112 Bankr. at 936.

75. The third and final requirement for attachment is that the debtor must have rights in the collateral. U.C.C. § 9-203(1)(c) (1987). This requirement may only be stating the obvious, but the phrase "rights in the collateral" is not defined in the Code. Clearly, an owner has rights in property and a thief who has mere possession does not. It is also clear that the debtor does not have to be an owner to create an enforceable security interest. However, it is not clear on the continuum between actual ownership and mere possession what relationship with collateral establishes rights sufficient to create a security interest in goods that the debtor does not own. In general, it appears that the debtor must have the "power" to create a security interest.

Because "rights" is not defined, other Code sections are relevant. For example, § 1-103 provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions." U.C.C. § 1-103 (1987). Thus, the debtor can obtain the power to create a security interest through any of the bodies of law set out in § 1-103. Also, under § 2-403(1)(b), purchasers are granted greater rights than their transferor had. Further, because secured parties are treated as purchasers under § 1-201(32) and (33), a secured party has the status of a purchaser under § 2-403.

This "rights" issue is a potential problem in several agricultural lending situations. One such situation involves a farmer who leases some or all of the land he farms, and who pledges the crops produced on this leased land as collateral. The farmer's rights in the growing crops on this leased land will be determined by the type of lease involved. If a cash lease is involved, the debtor farmer has an interest in all of the crops grown on the leased land. *Finley v. McClure*, 22 Kan. 637, 567 P.2d 851 (1977). However, the farmer with a crop-share lease has the power to create a security interest only in that portion of the crops that the farmer is entitled to under the crop-share lease. *See, e.g.*,

The value of the crops comes with maturity. Even under most *pre-UCC* law, severed crops became personal property upon severance, and

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KAN. STAT. ANN. §§ 58-2525, 59-1206 (1986). *But see* Metropolitan Life Ins. Co. v. Reeves-Gustafson, 228 Neb. 233, 422 N.W.2d 72 (1988). Crops should be treated as personal property rather than part of the real estate. The lease should not affect the landowner's interest in growing crops for which the landowner is paying all of the input costs.

The question of ownership arises when the farmer rents his or her land to a chicken breeder or seed company and then uses the chickens or eggs or grain as collateral. *Germany v. Farmers Home Admin.*, 73 Bankr. 19 (Bankr. S.D. Miss. 1986). Debtor, a farmer, and a chicken breeder entered into an egg production agreement which provided that: 1) the farmer would keep the breeder's chickens and collect the eggs; 2) title to the chickens would remain in the breeder who could remove them if the farmer failed to perform his duties; and 3) the farmer would be paid an amount for each chicken he maintained and another amount for each egg that the breeder picked up. Before going bankrupt, the farmer assigned one-half of his income from this contract to the Farmers Home Administration (FmHA). FmHA claimed the assignment was protected from the trustee in bankruptcy because the FmHA had a security interest in "farm products." The court concluded that ownership never vested with the debtor farmer because he had no rights in the collateral; all the debtor had was a services contract terminable at the will of the breeder. *Id.* at 22. At best, FmHA merely had an interest in the farmer's contract for services. FmHA did not assert that it relied upon the farmer's apparent ownership or lacked notice of the breeder's arrangement with the farmer. Moreover, nothing in the case indicated that FmHA checked the public records to determine if the breeder had filed a financing statement. Arguably, the farmer and the breeder had a bailment relationship. Some courts have held against the bailor (breeder) "where the debtor gains possession of collateral pursuant to an agreement endowing him with any interest other than naked possession." *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 214 (Okla. 1977). *See also* *Kinetics Technology Int'l Corp. v. Fourth Nat'l Bank*, 705 F.2d 396 (10th Cir. 1983). Apparently, FmHA had no way to determine from public records who owned the birds and the eggs. This same problem may arise when a seed company contracts with a farmer to raise, on farmer's land, seed grain. These contracts may also be referred to as bailments because they provide that the seed will be furnished by the company and the seed crop produced will at all times be the property of the seed company.

The rights issue may also arise when the debtor is a commercial feedlot operator, because animals in the facility often will be owned by people who have hired the operator to fatten them. The Oklahoma Court of Appeals considered this issue in *National Livestock Credit Corp. v. First State Bank of Harrah*, 503 P.2d 1283 (Okla. Ct. App. 1972), and concluded that the feedlot-debtor cannot create a security interest in animals that they do not own but hold as a bailee for the limited purpose of fattening. Thus, owners of cattle being fattened should make sure their animals are clearly identifiable by utilizing, for example, particular ear tags or brands.

The often difficult distinction between ownership and mere possession may potentially mislead the bailee's creditors, as discussed in the above cases involving farmers who produce eggs and seed grain. Thus, it is important to examine how much control the feedlot operator has. For example, if the operator is authorized to sell the animals without consulting the owner and there is no specific identification of the animals, the debtor may have the power to create a security interest in animals that do not belong to him.

*In re Cook*, 63 Bankr. 789 (Bankr. D.N.D. 1986), is another case in which the debtor did not own the collateral. Even though the nondebtor son in *Cook* held title in

the tenant would only have an interest in the tenant's proportionate share.<sup>76</sup> Thus, it makes no sense to say a tenant can create a security interest in the crops only while they are growing. This is of no value to the lender if it must foreclose. Moreover, as indicated earlier, the Illinois legislature made clear that growing crops are personal property and real estate interests cannot claim growing crops as realty.<sup>77</sup>

A landlord should have rights in the crops the moment they are planted. Crops are personal property, not real estate, and personal property law should govern. To be sure, a lessee has exclusive possessory rights to the land during the term, and traditionally a share of the crop is also considered to be rent. However, this does not mean a landlord has no rights in growing crops. If the landlord pays a percentage of the cost of seed, fertilizer, and chemicals, it is difficult to conclude that the landlord has no rights in the crops growing on the land prior to severance. Further, a crop-share lease is similar to a partnership with each partner

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cattle claimed by the secured party, this fact was not dispositive as to whether his debtor parents, who had possession of the cattle, had rights sufficient to grant a security interest in the cattle. The debtor may possess sufficient rights in collateral if the true owner agrees to the debtor's use of the cattle as collateral or if the true owner is estopped to deny creation of the security interest. The parties' intent is a key factor in determining whether sufficient rights exist and the lender has the burden of proving this element. *See also In re Atchison*, 832 F.2d 1236 (11th Cir. 1987). In *Atchison*, the owner personally signed the security agreement on behalf of the corporation and the equipment that he owned was being used by the corporation in the operation of the corporation business. The owner's permission to use his goods as collateral gives the debtor (corporation) sufficient rights for attachment purposes. *Id.* at 1239. The court noted that tests employed by courts to define rights include: 1) the owner's permission to use goods as collateral gives the debtor sufficient rights to create a security interest; and 2) the debtor's right to use and control the collateral gives the debtor sufficient rights to create a security interest. *Id.* *But see Thorp Credit, Inc. v. Wuchter*, 412 N.W.2d 641 (Iowa Ct. App. 1987).

A final example involves an interest gained by virtue of § 2-403(1)(b). In this situation a farmer delivers and sells grain to an elevator and receives a bad check from the elevator. The lender has a perfected security interest in the inventory of the elevator, which consists of company-owned grain. Does the elevator have sufficient rights in the collateral so that the lender's security interest will attach to the grain purchased with a bad check? A number of cases relying on § 2-403(1)(b), which gives the elevator voidable title and the power to transfer a good title to a good faith purchaser for value, have held that it does. Because the definition of "purchaser" in § 1-201(32) and (33) includes a secured party, generally the only question is whether the secured party acted in good faith. *See Samuels & Co. v. Mahon*, 526 F.2d 1238 (5th Cir. 1976), *cert. denied*, 429 U.S. 834 (1976); *In re McLouth Steel Corp.*, 22 Bankr. 722 (Bankr. E.D. Mich. 1982); *In re Western Farmers Ass'n*, 6 Bankr. 432 (Bankr. W.D. Wash. 1980); *Swets Motor Sales, Inc. v. Pruisner*, 236 N.W.2d 299 (Iowa 1975). When poultry, livestock, or perishable commodities are involved, the unpaid producer is given priority over the perfected secured creditor of the buyer. *See generally* 7 U.S.C. §§ 196(b), 197(e) (1989).

76. *See Babcock v. Mississippi River Power Co.*, 113 F.2d 398 (7th Cir. 1940).

77. *See supra* note 68 and accompanying text.

making a contribution and each having an undivided interest in the output of the arrangement. If a crop failure occurs, the landowner and the tenant each get nothing. The landlord's share of the crops comes *only* from the crops produced on the rented land.

Some state statutes provide that landowners with crop-share leases have rights in the crops as soon as the crops are planted.<sup>78</sup> In other states applying the common law, the landowner is considered the owner of a proportion of the crops being produced on the leased land. For example, in *In re Sumner*,<sup>79</sup> the bankruptcy court held that under Oregon law the lessor and lessee in a crop-share lease both have an undivided interest in the crops.<sup>80</sup> One must note that under federal farm programs, both landlord and tenant must sign up to participate. The government benefits allocated to the land will be paid to the tenant and landowner in the same proportion as the crops are shared. Some states treat growing crops as personal property in other contexts, such as under the doctrine of emblements, decedent estates, and landlord liens.<sup>81</sup> The upshot is that the landlord's share of the crops should not be considered an asset of the tenant's bankruptcy estate.<sup>82</sup>

#### *D. Unperfected Liens and the BFP Test*

The bankruptcy trustee, under section 545(2), may avoid statutory liens that are either unperfected or not enforceable against a bona fide purchaser (BFP).<sup>83</sup> This section does not define perfection or when a lien is not enforceable against a BFP.<sup>84</sup> Congress apparently intended for these questions to be decided under state law,<sup>85</sup> and courts have struggled

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78. See, e.g., KAN. STAT. ANN. § 58-2525 (1983). See also *Wiehl v. Winslow*, 118 Kan. 147, 149, 233 P. 802 (1925) (landlord has distinct interest in crops from the time of sowing).

79. 69 Bankr. 758 (Bankr. D. Or. 1986).

80. See *DeWolfe v. Kupers*, 106 Or. 176, 211 P. 297 (1923); *Halsey v. Simmons*, 85 Or. 324, 166 P. 944 (1917).

81. E.g., *Finley v. McClure*, 222 Kan. 637, 567 P.2d 851 (1977), KAN. STAT. ANN. §§ 58-2525, 59-1206 (1983). But see MINN. STAT. ANN. § 557.10-12 (West 1988).

82. 11 U.S.C. § 541 (1988).

83. *Id.* § 545(2).

84. See *infra* note 96.

85. See *In re Marino*, 813 F.2d 1562, 1565 (9th Cir. 1987) (powers of the Bankruptcy Code § 544(a) bona fide purchaser of real property are defined by state law); *In re Phillips Constr. Co.*, 579 F.2d 431, 432 (7th Cir. 1978) (upholding the validity of a mechanic's lien).

Courts also use state law to "determine the 'underlying property interests and commercial arrangements' at issue in bankruptcy proceedings." *Selby v. Ford Motor Co.*, 590 F.2d 642, 646 (6th Cir. 1979) (citing *Chicago Bd. of Trade v. Johnson*, 264 U.S. 1, 10 (1924)). See also *In re Anchorage Int'l Inn, Inc.*, 718 F.2d 1446, 1451 (9th Cir. 1983) (applying state law in determining that a lien on a liquor license was not avoidable under Bankruptcy Code § 545). However, states cannot impose their own priorities in a bankruptcy proceeding. E.g., *In re Loretto*, 898 F.2d 715, 718 (9th Cir. 1990).

with this section. Thus, all statutory liens that are not recorded or perfected by a lien holder's possession and all statutory liens that do not specifically provide for priority over purchasers are vulnerable.

Generally, the date the bankruptcy petition is filed determines whether the lien is perfected. However, section 546(b) provides an exception, and permits postbankruptcy perfection. As indicated earlier,<sup>86</sup> this section recognizes any state law "grace period" for perfection. Therefore, if under state law a statutory lien still may be perfected when bankruptcy occurs and that perfection can relate back to a prebankruptcy date, the lien will be perfected on the date the petition is filed.<sup>87</sup>

Section 545(2) invalidates a lien that "is not . . . enforceable against a bona fide purchaser that purchases such property at the time the commencement of the case, whether or not such a purchaser exists."<sup>88</sup> Under this section, a lien that is not enforceable against a real or *hypothetical* bona fide purchaser of the liened goods can be avoided by the trustee. The legislative history concerning the BFP avoidance power under the predecessor section to 545(2) stated that "[t]he holders of such liens [statutory] have reason to know that their security is extremely vulnerable."<sup>89</sup>

Federal courts have struggled with the BFP test. Although state law determines property rights, many states have no clear rules for determining whether a particular lien is enforceable against a BFP. Congress did not define BFP, and neither section 545 nor the legislative history indicates that the rights of a BFP can vary depending upon the circumstances. Consequently, federal courts have developed their own standards for determining whether statutory liens are avoidable.

Unfortunately, the federal courts' standards are not always consistent or clear.<sup>90</sup> Secret liens, liens that the holder is not required to perfect either by filing or possession, present the most difficulties.

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86. See *supra* notes 58-59 and accompanying text.

87. E.g., *In re Butler Construction Co.*, 110 Bankr. 281 (Bankr. W.D. Ky. 1989).

88. 11 U.S.C. § 545(2) (1988).

89. S. REP. No. 1159, 89th Cong., 2d Sess. 7 (1966).

90. E.g., *In re Cummings*, 656 F.2d 1262, 1265 (9th Cir. 1981) (lien on personal property created by statute is ineffective against a BFP and, therefore, ineffective against a trustee in bankruptcy); *In re Mission Marine Assoc.*, 633 F.2d 678, 681 (3d Cir. 1980) (lien avoidable unless state statute requires actual or constructive notice); *In re Trahan*, 283 F. Supp. 620 (W.D. La.), *aff'd per curiam*, 402 F.2d 796 (5th Cir. 1968), *cert denied sub. nom.* *Bernard v. Beneficial Fin. Co.*, 394 U.S. 930 (1969) (lien only avoidable if lien is enforceable against BFP in factual circumstances of case); *In re Allgeier & Dyer, Inc.*, 18 Bankr. 82, 88 (Bankr. W.D. Ky. 1982) (not avoidable if meets all statutory lien requirements); *In re Chesterfield Developers, Inc.*, 285 F. Supp. 689, 691 (S.D.N.Y. 1968) (if more than one type of BFP under state law, the lien must be enforceable against all for the trustee to be able to avoid the lien).

### *E. Producer Liens*

Secret liens and section 545(2) were recently considered by the Ninth Circuit Court of Appeals in *In re Loretto Winery Ltd.*<sup>91</sup> In *Loretto Winery*, the court was confronted with an unrecorded and nonpossessory producer's lien. Producers sold grapes to Loretto Winery (debtor) to be made into wine and wine products. Shortly after receiving the grapes, the debtor filed a bankruptcy petition. Under a California statute,<sup>92</sup> a producer automatically receives a lien on any farm product delivered and sold to a processor.<sup>93</sup> The lien is complete upon the date of the last delivery by the producer, has no formal perfection requirements, and attaches to the product sold in unprocessed or processed form so long as it remains in the possession or control of the processor. The trustee sought to avoid this lien under section 545(2), arguing that it was a secret lien and unenforceable against a BFP when the petition was filed. The court, with one judge dissenting, held that the trustee could not avoid the state statutory lien because the lien would be enforceable against a BFP under California law.<sup>94</sup>

Noting that a statutory lien can be avoided if it is not perfected *or* not enforceable against a BFP when the petition is filed, the court's analysis focused on the purchaser requirement, inasmuch as no perfection requirements existed.<sup>95</sup> Regarding section 545(2)'s hypothetical BFP, the

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91. 898 F.2d 715 (9th Cir. 1990). Other courts have considered this issue. *See, e.g.*, *In re Martin Exploration Co.*, 731 F.2d 1210 (5th Cir. 1984); *In re Tape City, U.S.A., Inc.*, 677 F.2d 401 (5th Cir. 1982); *In re Lowery Bros., Inc.*, 589 F.2d 851 (5th Cir. 1979); *Trahan*, 283 F. Supp. 620. *Martin* and *Tape City* involved § 545(2) whereas the other two cases involved § 545's predecessor § 67(c)(1)(B), codified at 11 U.S.C. § 107(c)(1)(B), which is substantively similar. Two other cases considering the old provision are *In re Mission Marine Assocs., Inc.*, 633 F.2d 678 and *In re J.R. Nieves & Co.*, 446 F.2d 188 (1st Cir. 1971). For a case dealing with state and federal maritime liens, see *In re Bay State Yacht Sales, Inc.*, 117 Bankr. 16 (Bankr. D. Mass. 1990) (state lien avoidable under § 545(2) but the federal lien was not).

92. CAL. FOOD & AGRIC. CODE §§ 55632-53 (West 1986 & Supp. 1990). For an interesting discussion of the California producer's lien that appeared before *In re Loretto Winery Ltd.*, 898 F.2d 715 (9th Cir. 1990) was decided, see Note, *The California Agricultural Producer's Lien, Processing Company Insolvencies, and Federal Bankruptcy Law: An Evaluation and Alternative Methods of Protecting Farmers*, 36 HASTINGS L.J. 609 (1985).

93. Producer liens are not uncommon. Ohio recently enacted an agricultural producer's lien that, once perfected, purports to protect the producer in the event of the processor's insolvency. The statute provides that the producer who records its lien within 60 days of delivery apparently has priority over all secured creditors of the processor and all warehouseman's liens. Nothing is said about bona fide purchasers. *See OHIO REV. CODE ANN.* § 1311.55 (Anderson Supp. 1990).

94. *Loretto Winery*, 898 F.2d at 724. Whether state statutory liens are enforceable against bona fide purchasers is determined by state law. *In re Tropicana*, 24 Bankr. 381, 382-83 (Bankr. C.D. Cal. 1982).

95. *Loretto Winery*, 898 F.2d at 718-19.

court concluded that Congress intended state law to be used to determine bankruptcy property disputes, and specifically, to determine whether a state statutory lien is good against a BFP.<sup>96</sup> Because the lien statute did not specially provide that the lien would be enforceable against a BFP, and no state precedent law existed, the court applied its own analysis. Initially, the majority stressed that the producer's lien is not only the key to California's extensive statutory scheme designed to protect unpaid producers; there is clear evidence that the California legislature also intended to guarantee farmers full payment for their farm products.<sup>97</sup>

California imposes harsh penalties for impeding the producer's lien. For example, if a processor removes the product to which the lien attaches to another state, removes it from the processor's ownership or control, or does not pay off the lien with proceeds from the sale of the product, the processor's license can be suspended or revoked, and the processor is subject to civil penalties of \$500 per violation.<sup>98</sup> The processor's sale of farm products or processed products without using the proceeds to pay the producer is a misdemeanor subjecting the processor to a fine ranging from \$500 to \$2000 or up to one year in jail or both.<sup>99</sup> This treatment persuaded the majority that the California legislature intended to make the lien unavoidable.<sup>100</sup> Interestingly, the statute is silent on whether the producer may enforce the lien against a purchaser, but it is valid only if the farm products remain in the processor's possession.<sup>101</sup>

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96. "Bona fide purchaser" (BFP) is defined in many different ways. The following are examples of how different states have defined a bona fide purchaser.

A BFP is one who purchased property for value without notice of any defects in the seller's title. *Walters v. Calderon*, 25 Cal. App. 3d 863, 102 Cal. Rptr. 89, 97 (1972).

A BFP is one who pays valuable consideration and acts in good faith without notice of any third party's rights with respect to the property sold. *J.C. Equipment, Inc. v. Sky Aviation, Inc.*, 498 S.W.2d 73, 75 (Mo. Ct. App. 1973).

A BFP for value is one who pays the seller valuable consideration and does not have notice of another's claim of right to, or equity in, the property prior to the buyer acquiring title. *Snuffin v. Mayo*, 6 Wash. App. 525, 494 P.2d 497 (1972).

A BFP is one who buys property or to whom a negotiable document of title is transferred in good faith and without notice of any defense or claim against the property or document. The UCC does not use the bona fide purchaser, but instead uses good faith purchaser and buyer in the ordinary course, and taking by due negotiation. *See U.C.C. §§ 1-201(9), 2-403(1), 1-201(19), 7-501(4), 1-201(25)*. *See also id.* §§ 9-307(1), 3-302, 3-305.

97. *See Note, supra* note 92, at 613-15, in which the author summarizes the changes made in the producer's lien statute to assure producers would be paid.

98. CAL. FOOD & AGRIC. CODE §§ 55872, 55922 (West 1986).

99. *Id.* §§ 55901, 55905.

100. *Loretto Winery*, 898 F.2d at 722.

101. Some states do make specific reference to purchasers of products subject to liens. Others state that the lien will not be good against innocent purchasers. *E.g.*, MICH. COMP. LAWS ANN. § 570.331 (West 1967). Others provide that it will only be good against purchasers with notice. *E.g.*, KAN. STAT. ANN. § 58-2526 (1983) (lien against crops for unpaid rent).

Arguably, the possession requirement and the failure to make the lien enforceable against a BFP permit the negative inference that a lien is not to be enforceable against a BFP. The harsh penalties also might have been considered a substitute for making the lien unenforceable against a purchaser of the liened goods.

Addressing hypothetical BFP avoidance power, the court concluded that the test is whether the lien would be enforceable against a BFP in the factual circumstances of the actual bankruptcy.<sup>102</sup> The court focused on two factual circumstances. First, because the processor possessed the grapes when the bankruptcy petition was filed, the trustee must be considered to have possession at the filing.<sup>103</sup> Second, the producer's lien is only effective so long as the processor has possession.<sup>104</sup> The court would not classify the trustee as a hypothetical BFP because, in its words, "we will not violate Congress' intent and ignore state law by assuming that the hypothetical bona fide purchaser has possession when the debtor actually had possession at the moment of bankruptcy."<sup>105</sup> The majority ignored the fact that section 545 mandates that the statutory lien must be enforceable against a purchaser who, at the date of the petition, would buy the grapes. In other words, the test is whether the secret lien is enforceable if someone had purchased the grapes from the processor. There is nothing to indicate Congress intended that possession by the debtor (bankrupt) could prevent the trustee from avoiding a lien.<sup>106</sup> Moreover, in most cases, statutory liens will be effective if the person against whom the lien is directed has possession. Accordingly, the BFP avoidance power is neutralized whenever the debtor has possession of the goods.

The dissent noted that Congress intended the avoidance powers to be pursued vigorously.<sup>107</sup> Congress's priority rules for creditors in bankruptcy would be substantially disrupted if all of the numerous statutory liens, regardless of substance, were to be considered enforceable liens in bankruptcy. Under the Bankruptcy Code, lien creditors and perfected

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102. *Loretto Winery*, 898 F.2d at 721. This is essentially the test applied in *In re Trahan*, 283 F. Supp. 620 (W.D. La.), *aff'd*, 402 F.2d 796 (5th Cir. 1968), *cert denied sub. nom. Bernard v. Beneficial Fin. Co.*, 394 U.S. 930 (1969) (lien only avoidable if lien is enforceable against BFP in factual circumstances of case).

103. *Loretto Winery*, 898 F.2d at 721.

104. *Id.*

105. *Id.*

106. The BFP test of § 544(a)(3) is similar, and the legislative history and cases construing this section are relevant to § 545(2). See, e.g., *McCannon v Marston*, 679 F.2d 13 (3d Cir. 1982); *In re Great Plains Western Ranch Co.*, 38 Bankr. 899 (Bankr. C.D. Cal. 1984); *In re Euro-Swiss Int'l Corp.*, 33 Bankr. 872 (Bankr. S.D.N.Y. 1983).

107. *Loretto Winery*, 898 F.2d at 725 (Breezer, J., dissenting).

secured creditors generally are considered to have secured claims.<sup>108</sup> In bankruptcy, the creditor having a secured claim has a valid property interest in specific property of the debtor, and this claim must be satisfied before the property can be made available to unsecured creditors. However, Congress placed limits on lien creditors and certain perfected secured creditors via the avoidance powers given to the trustee in sections 544, 545, 547, 548, and 551. Section 545 was designed in part to place restrictions on a state's ability to disrupt Congress's distribution of assets scheme by enacting statutory liens.<sup>109</sup>

The dissent advocated that a statutory lien should be enforceable in bankruptcy only if the statute creating it requires actual or constructive notice to a BFP.<sup>110</sup> The dissent also argued that notice requirements must be uniformly applied, and if states want to give certain creditors secured status, those liens must have formal notice requirements.<sup>111</sup> Secret liens should not be countenanced. The producer's lien statute was a secret lien because it had no perfection requirements. The dissent concluded that while the California courts had not determined whether the producer's lien would be good against a purchaser, California courts had a clear policy against upholding secret liens.<sup>112</sup> Accordingly, the courts would follow the long-established California policy against enforcement of secret liens against a purchaser. The majority recognized that California law generally protected a BFP against secret liens, but concluded that the only test is whether the lien in question is good against a BFP under the California statutory scheme.<sup>113</sup>

Apparently, the trustee in *Loretto* did not try to avoid the producer's lien under section 544(a)(1), because it was not discussed. The trustee may have determined that the lien creditor could not have priority over the secret statutory producer's lien under California law, or the trustee may have just overlooked it.

The farm products sale in *Loretto* occurred in 1985 when the federal farm products rule was not in effect. Had the sale occurred after December 23, 1986, the BFP question would have been even more complicated. Concerning the sale of farm products, the United States Code provides:

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108. 11 U.S.C. § 506(a) (1988).

109. See S. REP. No. 1159, 89th Cong., 2d Sess 2-3 (1966); S. REP. No. 989, 95th Cong., 2d Sess. 86 (1978). See also Schneyer, *Statutory Liens Under the New Bankruptcy Code—Some Problems Remain*, 55 AM. BANKR. L.J. 1-7 (1981).

110. *Loretto Winery*, 898 F.2d at 725 (Breezer, J., dissenting).

111. *Id.* *In re Martin Exploration Co.*, 731 F.2d 1210 (5th Cir. 1984) and other Fifth Circuit decisions appear to support the majority. *In re Mission Marine Assoc.*, 633 F.2d 678 (3d Cir. 1980) supports the dissent.

112. *Loretto Winery*, 898 F.2d at 725 (Breezer, J., dissenting).

113. *Id.* at 720.

Except as provided in subsection (e) [when buyer has notice] of this section and notwithstanding any other provisions of Federal, State or local law, a buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a *security interest created by the seller*, even though the security interest is perfected; and the buyer knows of the existence of such interest.<sup>114</sup>

Arguably, section 1631 is a comprehensive scheme and preempts all state law concerning the sale of farm products. However, the language of section 1631 indicates that it does not cover involuntarily created interests in farm products; section 1631(d) applies to *security interests created by the seller*. Security interest is defined for purposes of section 1631 as "an interest in farm products that secures payment or performance of an obligation."<sup>115</sup> This definition is conceivably broad enough to cover involuntarily created interests in farm products like statutory liens or judicial liens. Yet, "security interest" is a term of art in the UCC, and it includes only consensual interests created in property to secure obligations and payments. Moreover, the focus of section 1631 and of the legislative history is on consensual security interests. Finally, even assuming that the definition of "security interest" is broad enough to cover statutory and common law liens, the question remains whether a statutory or common law lien is a security interest "created" by the seller.<sup>116</sup> I think not.

If this statute were to apply, the trustee could always win in a state having a presale notification system requiring a secured party to give appropriate written notice to buyers before the sale in order to preserve the lien. The trustee was an unknown purchaser.<sup>117</sup> On the other hand, if a state has opted for what section 1631 deems a "central filing system"<sup>118</sup> and the secured party had filed, it would be protected. But if the secured party had not filed, it would seem that the trustee should win because a BFP would have no notice. Congress probably did not intend to make statutory liens subject to section 1631.

Currently, some states require statutory liens to be filed. At least one state has a rule specifically dealing with the enforceability of filed statutory liens against a purchaser. Since June 30, 1988, Minnesota has

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114. 7 U.S.C. § 1631(d) (1990) (emphasis added).

115. *Id.* § 1631(c)(7).

116. U.C.C. §§ 9-307(1), 9-306(2) (1987). Section 1631 was promulgated in direct response to criticism of Article 9's farm product rule, which provided that the sale of farm products did not cut off a perfected security interest if the secured party had not consented to the sale.

117. 7 U.S.C. § 1631(e)(1) (1990).

118. *Id.* § 1631(e)(2).

had a priority rule dealing with the sale of farm products subject to a statutory lien.<sup>119</sup> A statutory lien is defined as a consensual or nonconsensual lien on farm products, but *does not* include a landlord's lien or security interest under the UCC.<sup>120</sup> The priority rule<sup>121</sup> is almost identical to the federal farm products rule in 7 U.S.C. § 1631. A buyer who buys farm products from a seller engaged in farming buys free of a statutory lien even though it is perfected and the buyer knows of its existence *unless* the lienholder has perfected its lien and the buyer has received within one year before the sale of the farm products an appropriate written notice of the lien and fails to pay in the manner specified in the notice. A lien notice is effective for five years after the date the lien notice is received by the buyer, commission merchant, or seller. Commission merchants and sellers are given the same protection as buyers. The proceeds received by the seller are subject to the statutory lien.

It seems that in Minnesota a statutory lien would prevail in bankruptcy under section 545(2) if the holder had filed in the appropriate place and attempted to give correct notice to all known buyers. It is unclear how a lien holder determines who the buyers are.<sup>122</sup> It is also not clear how courts will deal with the BFP concept of section 545 when a lien was perfected but no attempt was made by the holder to give written notice to any buyers. Arguably, it should make no difference. Section 545 provides that the statutory lien can be avoided when the lien "is not perfected *or* enforceable . . . against a bona fide purchaser."<sup>123</sup> If the BFP test is applied, it is of course impossible for a hypothetical BFP such as the trustee to have received written notice. Literal application of the Minnesota rule would make it impossible for a statutory lien to survive an attack via section 545(2). The lien would not be valid against a purchaser under state law because no notice was received.

The *Loretto* majority's concern about the producer being protected is justifiable. Without a statutory lien, the unpaid producer is an unsecured creditor if he or she has sold products on credit,<sup>124</sup> or for a bad check from an insolvent buyer without a demand in writing to return the farm products within ten days after the processor (buyer) received the prod-

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119. MINN. STAT. ANN. § 223A.02 (West Supp. 1990).

120. *Id.* § 223A.02(4).

121. *Id.* § 223A.03.

122. *Cf.* 7 U.S.C. § 1631(h) (1990).

123. 11 U.S.C. § 545 (1988).

124. Sometimes producers have no choice but to sell products on credit. This is particularly true in California. Obviously, producers can avoid any problems with the creditworthiness of buyers by being paid in cash or a certified or cashier's check or obtaining a letter of credit. As a practical matter these options are not available to producers.

ucts.<sup>125</sup> Such a producer will lose in bankruptcy and has no practical way to protect itself. Normally the processor will be financed by a creditor who has perfected a security interest in all of the processor's inventory (present and future). Technically, the producer-sellers could have protected themselves under Article 9,<sup>126</sup> but this protection is unavailable as a practical matter. The requirements of section 9-312(3), which gives to a holder of a purchase money security interest in inventory a super-priority, must be satisfied. Assuming that a producer's interest is a purchase money interest,<sup>127</sup> a producer must satisfy the attachment and perfection requirements.

To have attachment, the secured party (producer-seller) would have to obtain a signed security agreement from the processor-buyer granting it a security interest in inventory.<sup>128</sup> It is difficult to imagine a processor signing a security agreement each time it buys from a producer. Moreover, to defeat the processor's financier, the producer would have to file a financing statement signed by the debtor (processor). In addition, because inventory is involved, the financing statement would have to be filed

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125. See 11 U.S.C. § 546(c). Among other things, this section provides that a seller "may not reclaim any such goods unless such seller demands in writing reclamation of such goods before ten days after receipt of such goods by the debtor . . . ." 11 U.S.C. § 546(c)(1). Section 546(d) provides that the same 10-day rule applies to farmers or fishermen who sold their respective products to a grain storage facility or fish processing facility. For a general discussion of § 546, see Wallach, *The Unpaid Seller's Right to Reclaim Goods: The Impact of the Uniform Commercial Code and the Bankruptcy Acts of 1898 and 1978*, 34 ARK. L. REV. 252 (1980).

126. See, e.g., *In re Samuels*, 526 F.2d 1238 (5th Cir. 1976), cert. denied, 429 U.S. 834 (1976) (rancher who sold cattle and received a bad check lost in bankruptcy because he was an unsecured creditor and had no remedy against the financier of the packer that had purchased the cattle with the bad check). For other cases following the *Samuels* approach, see *Action Indus., Inc. v. Dixie Enters., Inc.*, 22 Bankr. 855 (Bankr. S.D. Ohio 1982); *In re McLouth Steel Corp.*, 22 Bankr. 722 (Bankr. E.D. Mich. 1982); *In re Western Farmers Ass'n*, 6 Bankr. 432 (Bankr. W.D. Wash. 1980).

The problems raised by *Samuels* and by the bankruptcy of American Beef Packers prompted Congress, in 1976, to amend the Packers and Stockyards Act by adding 7 U.S.C. § 196(b), which requires packers to hold in trust all proceeds from the sale of livestock. From the perspective of the livestock industry, *Samuels* no longer controls in most cases. However, note that § 196(b) only applies to packers buying more than \$500,000 worth of *livestock*. It does not apply to grain, dairy products, and poultry. In 1987, Congress amended the Packers and Stockyard Act to cover poultry. 7 U.S.C.A. § 197 (West Supp. 1990). Recently, dairy farmers sought federal legislation to set up a prompt payment system and a trust fund to protect them against future bankruptcies of milk processors. Congress recently amended the Perishable Agricultural Commodities Act, 7 U.S.C.A. § 499e (1984), by adding a trust fund. 7 U.S.C.A. § 499e(c) (West Supp. 1984). Compare it with § 196(b) of the Packers and Stockyards Act. One difference is that the perishable commodities trust fund has a 30-day rather than a 15-day notice requirement.

127. See *supra* note 126 and accompanying text.

128. See U.C.C. §§ 9-203, 9-303.

before the farm products were delivered to the processor, and the producer must give written notice to perfected secured parties who filed financing statements covering the processor's inventory.<sup>129</sup> In short, the suggestion that the producer can protect itself under Article 9 is meaningless.

### III. THE FUTURE

#### A. *The ABA Lien Committee: Proposed Changes*

The severe economic problems experienced by the agricultural sector in the 1970s and 1980s raised many questions about agricultural credit. Some questions involved which rules govern agricultural credit transactions. The numerous state agricultural liens not subject to Article 9 were difficult to deal with in state conflicts as well as in bankruptcy. It also became apparent that the UCC's uniformity concept was being eroded. These questions prompted the ABA to form a subcommittee of the Agricultural and Agribusiness Finance, Commercial Financial Services Committee, Section of Business Law, American Bar Association ("Lien Committee"), to study agricultural liens. The Lien Committee was to survey the lien laws of all fifty states and consider whether agricultural liens could be coordinated with Article 9, and if so, how.

The Committee surveyed state lien laws to determine: 1) the type of lien, 2) the source of the lien, 3) the party protected, 4) the property to which the lien attaches, 5) whether the lien is possessory, 6) whether it must be filed, 7) when and how it attached, and 8) whether any priority provision exists. The project is completed<sup>130</sup> and the number of liens is overwhelming. Information about these liens has been condensed into Rapid Finder Charts containing the answers to the above-listed questions. A treatise-style analysis of each state's agricultural liens also exists.<sup>131</sup> The Lien Committee also developed a number of ways that the legal system should deal with agricultural liens and conflicting security interests:

1. No change;
2. Nonpossessory liens must be filed in the UCC records in the same manner as a security interest in the good would be, but no priority rule established;<sup>132</sup>

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129. *Id.* § 9-312(3)(a), (b).

130. The lien survey portion of the project was completed in large part because of the work of Martha Noble, Staff Attorney and Assistant Research Professor, National Center for Agriculture Law Research & Information, School of Law, University of Arkansas, Fayetteville.

131. The Committee manuscript, containing both the Rapid Finder Charts and the textual discussion, is about 800 pages.

132. This Committee option is called the minimalist option. It would amend § 9-

3. Nonpossessory liens must be filed in the UCC records in the same manner as a security interest in the good and if filed first will have priority over a subsequently perfected security interest in the *good*;<sup>133</sup>
4. A super-priority is given in *crops* to a secured creditor who supplies within one year of when crops become growing crops new value for goods or services used in the production of the crop;<sup>134</sup>

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310 by making its present language subsection (1) and adding a subsection (2), which reads as follows:

(2) When a person in the ordinary course of business furnishes services, labor, land or materials to a person engaged in farming operations with respect to goods subject to a security interest, a lien upon goods not in the possession of such person given by statute or rule of law for such services, labor, land, or materials may gain priority over a perfected security interest or protection against buyers of the goods only if:

- (a) the lien is enforceable against the debtor; and,
- (b) such person files a notice of the lien identifying such person as a lien claimant in the same place and the same manner, except only the lien claimant need sign the notice, as such person would file in order to perfect a security interest in such goods.

133. This Committee option is referred to as the maximalist option. It provides:

(2) When a person in the ordinary course of business furnishes service, labor, land, or materials to a person engaged in farming operations, a lien upon goods not in the possession of such person given by statute or rule of law for such services, labor, land, or materials takes priority over a conflicting security interest or other liens if, before the security interest is perfected:

- (a) the lien becomes enforceable against the debtor; and,
- (b) such person files a financing statement identifying such person as a secured party in the same place and manner as such person would file in order to perfect a security interest in such goods.

Changes would have to be made in § 9-402 as well as in § 9-104 to clarify that landlord liens would now be covered by Article 9.

Subsection 9-310(2) addresses nonpossessory agricultural judicial or statutory liens for services, labor, land, or materials that subsection 9-310(1) does not. Subsection 1 addresses only possessory liens.

134. Under this Committee option, § 9-312(2) would be amended by substituting the following:

(2)(a) A crop production security interest is a security interest in crops for a new value given while the crops are being produced, or not more than one year before the crops become growing crops by planting or otherwise, to enable the debtor to produce the collateral by acquiring goods or services to be used in producing the crop. Producing crops includes any activity that causally relates to the growing of crops or marketing of crops.

(b) Except as provided in subsection (c), a crop production security interest takes priority over an earlier perfected security interest, and also in the proceeds of the collateral, even though the person giving new value had knowledge of the

5. All creditors supplying production money would share pro-rata in the *farm products*;<sup>135</sup>
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earlier security interest.

(c) The priority provided for in subsection (b) is subject to these limitations:

(i) The crop production security interest has priority only to the extent that before the debtor receives value, or within ten days thereafter, a financing statement covering the collateral is filed.

(ii) An earlier perfected security interest that secures a purchase money obligation, or rent, for the land on which the crops were grown has priority to the extent of an amount of the obligation or rent that is determined by law to be proportionately and fairly attributable to the six-month period before the crops became growing crops by planting or otherwise.

(iii) Subsection (5) governs priority between conflicting crop production security interests.

(d) Creating or perfecting a crop production security interest shall not operate under any circumstances as a default on, an accelerating event under, or otherwise as a breach of, any note or other instrument or agreement of any kind or nature to pay debt; any loan or credit agreement; or any security arrangement of any kind or nature whether the collateral is real or personal property.

135. Under this Committee option, § 9-312(2) would be changed to read:

(2)(a) A perfected security interest in farm products and proceeds thereof for new value given to enable the debtor for the current production season to produce or to market the farm products by acquiring goods, services, or labor or by acquiring an operating loan for maintenance, insurance, general farm expenses, or reasonable household expenses, and given not more than six months before the farm products become growing farm products by planting or otherwise, takes priority over an earlier perfected security interest in the farm products, and also in the proceeds of the farm products, even though the person giving new value had knowledge of the earlier security interest in farm products. For the purpose of a debtor growing farm products with different production seasons, an indeterminate production season, or a continuous production season, all of the farm products subject to a farm products production security interest shall be deemed to become growing farm products on April 1.

(b) The priority provided for in subsection (a) is subject to these limitations:

(i) The farm products production security interest in farm products has priority only to the extent that before the debtor receives value, or within ten days thereafter, a financing statement covering the collateral is filed.

(ii) An earlier perfected security interest that secures a purchase money obligation, or rent, for the land on which the farm products were grown, a purchase money obligation on livestock, or an obligation for an operating loan for maintenance, insurance, general farm expenses, and for reasonable household expenses has priority over a farm products production security interest to the extent of an amount of the obligation or rent that is determined by law to be proportionately and fairly attributable to a one-year period beginning six months before the farm products became growing farm products by planting or otherwise.

(iii) Purchase money security interests in other goods not used to produce farm products, in equipment (whether or not used to produce the farm products), and inventory cannot be farm products production security in-

6. All perfected secured creditors who have contributed to production even if it is not directly linked to the current year product shall share pro rata in *farm products*;<sup>136</sup>
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terests.

(iv) When more than one farm products production security interest attaches to a farm product, they rank equally according to the ratio that the new value incurred with respect to each farm products production security interest bears to the total new value attributable to all of the farm products production security interests.

(v) A purchase money security interest in unused goods that are farm products, but are not crops or livestock or products of crops or livestock in their unmanufactured state, has priority over a conflicting security interest in the same collateral, but not its proceeds or products, if before the debtor receives value, or within ten days thereafter, a financing statement covering the collateral is filed. Upon consumption, a purchase money security interest in such farm products shall be a farm products production security interest if the security agreement and financing statement so provide.

(c) Creating or perfecting a farm products production security interest or security interest under subsection (2)(b)(iv) of this section shall not operate under any circumstances as a default on, an accelerating event under, or otherwise as a breach of, any note or other instrument or agreement of any kind or nature to pay debt; any loan or credit agreement; or any security arrangement of any kind or nature whether the collateral is real or personal property.

Section 9-310 is amended by making its present language subsection (1) and adding a subsection (2), which reads as follows:

(2) If the goods subject to such a lien are farm products, such lien takes priority over a perfected security interest in farm products only if it is a farm products production security interest in accordance with § 9-312(2) and only if the secured party complies with the requirements of § 9-312(2).

136. This Committee option would make agricultural liens subject to Article 9, but would develop a new relationship. This is called the attribution option. Section 9-312(2) would be changed to read:

(2)(a) A perfected security interest in farm products or their proceeds which represents new value given to enable the debtor for the current production season to produce or to market the farm products by acquiring goods, services, or labor or by acquiring an operating loan for maintenance, insurance, general farm expenses, or reasonable household expenses, and given not more than six months before the farm products become growing farm products by planting or otherwise, takes priority over an earlier perfected security interest in the farm products, and also in the proceeds of the farm products, even though the person giving new value had knowledge of the earlier security interest in farm products. For the purpose of this subsection, where a debtor has farm products with different production seasons, an indeterminate production season, or a continuous production season, all of the farm products subject to a farm products production security interest shall be deemed to become growing farm products on April 1.

(b) The priority provided for in subsection (a) is subject to these limitations:

(i) The farm products production security interest in farm products has priority only to the extent that before the debtor receives value, or within

7. *Priority as to conflicts between security interests in crops and/or conflicts between statutory liens determined by nonUCC rules;*<sup>137</sup> and

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ten days thereafter, a financing statement covering the collateral is filed.

(ii) An earlier perfected security interest that secures a purchase money obligation, or rent, for the land on which the farm products were grown, a purchase money obligation on livestock, or an obligation for an operating loan for maintenance, insurance, general farm expenses, and for the reasonable household expenses is a farm products production security interest to the extent of an amount of the obligation or rent that is determined by law to be proportionately and fairly attributable to a one-year period beginning six months before the farm products became growing farm products by planting or otherwise.

(iii) Purchase money security interests in other goods not used to produce farm products, in equipment (whether or not used to produce the farm products), and inventory cannot be farm products production security interests.

(iv) When more than one farm products production security interest attaches to a farm product, they rank equally according to the ratio that the new value incurred with respect to each farm products production security interest bears to the total new value attributable to all of the farm products production security interests.

(v) A purchase money security interest in unused goods that are farm products, but are not crops or livestock or products of crops or livestock in their unmanufactured state, has priority over a conflicting security interest in the same collateral, but not its proceeds or products, if before the debtor receives value, or within ten days thereafter, a financing statement covering the collateral is filed. Upon consumption, a purchase money security interest in such farm products shall be a farm products production security interest if the security agreement and financing statement so provide.

(c) Unless otherwise agreed, a security interest in farm products continues in products of the collateral and the security interest in products is a continuously perfected security interest if the interest in the original collateral was perfected.

(d) Creating or perfecting a farm products production security interest or security interest under subsection (2)(b)(iv) of this section shall not operate under any circumstances as a default on, an accelerating event under, or otherwise as a breach of, any note or other instrument or agreement of any kind or nature to pay debt; any loan or credit agreement; or any security arrangement of any kind or nature whether the collateral is real or personal property.

Section 9-310 is amended by making its present language subsection (1) and adding a subsection (2) which reads as follows:

(2) If the goods subject to such a lien are farm products, such lien takes priority over a perfected security interest in farm products only if it is a farm products production security interest in accordance with § 9-312(2) and only if the secured party complies with the requirements of § 9-312(2).

137. The state of Washington eliminated § 9-312(2) and provided instead that priority conflicts between security interests in crops are governed by WASH. REV. CODE §§ 60.11.010 to .140 (1990). This chapter has 14 sections relating to crop liens. Section 60.11.050 deals

8. Priority as to conflicts in farm products between agricultural lien holders and secured creditors is determined under section 9-312(5), except lien holders providing goods and supplies that are consumed during production will be given a super-priority if they give appropriate written notice to prior filed secured creditors prior to providing the goods or supplies.<sup>138</sup>

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with priorities of liens and security interests in crops. With certain exceptions, priority is based on when a lien or security interest is filed. Exceptions are made for landlord liens and service liens, and a security interest in crops is subordinate to a later-filed purchase money security interest in growing crops.

138. This proposal is contained in a June 5, 1991, memorandum from the Lien Committee to the ALI Study Committee. The substance of the proposal is set out below.

Under this proposal, agricultural liens (ag liens) would be covered by Article 9 but not required to satisfy the attachment requirements. Even though ag liens would be defined in Article 9, laws other than Article 9 would control when and how an ag lien is created. An ag lien would be defined in § 9-105 as:

A nonpossessory charge or interest in farm products to secure payment of a debt or performance of an obligation given by statute or rule of law to a person which in the ordinary course of business furnishes supplies or goods to a person engaged in a farming operation, but the term does not include a security interest. All ag liens would be required to be perfected by filing to have priority.

Section 9-310 would be amended by adding subsection (2), which would provide: An ag lien as defined in 9-105 is perfected and may take priority as provided for in 9-312 over a conflicting security interest, other ag liens or other liens if:

- (a) The ag lien becomes enforceable against the debtor; and
- (b) The holder of the ag lien files a financing statement identifying such holder as a secured party in the same place and manner as such holder would file in order to perfect a security interest in such goods.

Section 9-312(5)(a) & (b) would be amended to make them applicable to ag liens.

Section 9-312 would also be amended by the addition of subsection (8) which would provide:

(8) A perfected ag lien in farm products has priority over a conflicting security interest and other ag liens in the same collateral if:

- (a) the agricultural lienholder notifies in writing the holder of any conflicting security interest if the holder of a conflicting security interest had filed a financing statement covering the same types of collateral before the date of the filing made by the agricultural lienholder, and
- (b) the notification states that the agricultural lienholder giving the notice has or expects to provide goods or supplies describing such goods or supplies by item or type and the monetary amount and the notice is sent at least ten days prior to the providing of such goods or supplies, and
- (c) the holder of the conflicting security interest receives the notification within six months before the debtor receives possession of the goods and supplies, and
- (d) when more than one agricultural lienholder complies with this subsection (8), the ag liens share priority according to the ratio of the amount owed by the debtor to each of the agricultural lienholders for the ag lien.

The Lien Committee divided statutory agricultural liens into two categories. One involves sellers who sell goods on unsecured credit; examples include suppliers of seed, fertilizer, chemicals, and feed. If the buyer does not pay, these liens give the seller, as a matter of law, an interest in the products produced from the supplied goods. The Committee characterized these essentially as purchase money liens for the production of specific goods.<sup>139</sup> The other category includes liens for persons providing land where crops or animals are produced, or for persons providing labor or services that preserve or enhance the value of crops or animals. Liens in this group include landlord, harvester, veterinary, and feeder liens. It must be noted that the Lien Committee did not attempt to address producer's liens, and some of the proposals address all farm products and some deal with only crops. A complete discussion of these proposals will appear in an upcoming issue of the *Oklahoma Law Review*.<sup>140</sup> Some of the proposals will be briefly covered here.

### *B. Article 9 Should Cover All Financing Liens*

Currently, an American Law Institute committee, at the urging of the Permanent Editorial Board of the UCC, is studying whether Article 9 should be revised. One question this committee must confront is how to deal with agricultural credit questions that in many ways present unique issues. For example, Congress changed the farm products rule of section 9-307(1),<sup>141</sup> and enacted a special bankruptcy chapter<sup>142</sup> to deal exclusively with farmers. Congress also established trust funds to give unpaid sellers of livestock, poultry, and perishable commodities priority over perfected

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139. The purchase money concept is derived from U.C.C. §§ 9-107 and 9-312(2). The property to which the lien attaches is not the product supplied by the seller. Rather, the input supplies facilitate the production of the good to which the lien attaches. Thus, the interest is not a pure purchase money interest. Section 9-312(2) uses the concept of "new value given to enable the debtor to produce crops . . . ." Note that § 9-312(2) only applies to crops. It does not apply to livestock, poultry, or other animals. Section 9-107 gives a security interest to the seller when the security interest "is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used." U.C.C. § 9-107.

It must be noted that producers who sell goods on credit are, in effect, financing the processor and could have been included but were not, apparently because the focus is on financing producers, not how processors and buyers are financed.

140. Turner, Barnes, Kershen, Noble & Schumm, *Agricultural Liens and the UCC: A Report of Present Status and Proposals for Change*, forthcoming in OKLA. L. Rev. (1991).

141. 7 U.S.C. § 1631 (1988).

142. 11 U.S.C.A. §§ 1201-08, 1221-31 (West Supp. 1990).

secured parties of the buyers.<sup>143</sup> The United States Department of Agriculture, maintaining that Congress had given it the power to preempt state laws affecting government farm program payments, promulgated regulations providing that government payments made in the form of commodity certificates were not subject to state Article 9 rules, as well as Article 3 of the UCC.<sup>144</sup> State lien laws that are not covered by Article 9 but which grant lienholders specific rights in personal property normally covered by Article 9 have caused the law resolving priority battles concerning agricultural credit to be less than uniform.

When considering whether the basic premises of Article 9 should be changed, the genius of the drafters must be remembered. This genius is demonstrated by the fact that they condensed a series of complex, difficult to understand rules into fifty-five succinct sections containing relatively simple, understandable rules providing a clear and predictable framework for resolving conflicts.

Although it is beyond the scope of this Article to deal with all agricultural credit issues presenting problems for Article 9 application, it is appropriate to consider agricultural liens. As discussed earlier,<sup>145</sup> Article 9 applies to a limited number of nonconsensual possessory liens, but only as to priority. The statute or the common law creating the lien controls creation, perfection, and enforcement. Article 9 does not apply to the large number of nonpossessory liens, including landlord liens, that give an unpaid creditor a specific interest in personal property.

There is a need to have uniform, simple, and understandable rules dealing with all liens (consensual and nonconsensual) affecting farm products that are codified in one statutory scheme rather than being spread throughout a state code system or developed on a case-by-case basis. One approach is to make all liens subject to Article 9. This would make attachment, perfection, priority, and default rules applicable. Another possibility is to allow an interest in personal property to be created by operation of law but require perfection and make the priority and enforcement rules applicable. Article 9 could be changed to make only the perfection rules and priority rules applicable, or to make only the perfection rules applicable but modify them so that only the lienholder would be required to sign the financing statement.

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143. 7 U.S.C. § 196 (1988) (livestock). *See generally* *In re Gotham Provision Co.*, 669 F.2d 1000 (5th Cir. 1982); 7 U.S.C. § 197 (poultry); *id.* § 449(c) (perishable commodities).

144. 7 C.F.R. pt. 1470.4(b)(2) (1990). Courts are split on the validity of the regulations. *See In re George*, 119 Bankr. 800 (Bankr. D. Kan. 1990); *In re Rutz*, 104 Bankr. 128 (Bankr. S.D. Iowa 1989).

145. *See supra* text accompanying notes 18-40.

I prefer to make all creditors who want to be able to claim an interest in specific farm products subject to Article 9. Article 9 provides a complete set of understandable rules. All creditors can determine what their status would be relative to other creditors and to the trustee in bankruptcy if the debtor were to default. The default rules also are relatively straight-forward, and courts and attorneys are far more familiar with them than with the enforcement procedure of lien laws. There would be no need to develop a new set of terms and rules, which is not the case if a uniform agricultural lien law were created. Any creditor who supplies goods, labor, land, or services to a person engaged in a farming operation and who obtains an interest in farm products would be subject to Article 9. Conflicts concerning a security interest in farm products<sup>146</sup> or goods<sup>147</sup> would be determined under Article 9.

This is a significant departure from the current version of Article 9 in a variety of ways. First, all state liens, possessory and nonpossessory, must be repealed. Anyone wanting to obtain an enforceable security interest under Article 9 to secure a promise to pay or perform would have to comply with the attachment requirements.<sup>148</sup> Permitting a land-owner to obtain a security interest in growing crops is not a departure from the current UCC,<sup>149</sup> but requiring it is new. It makes sense to require this because the collateral is personal property, and the landlord liens are avoidable in bankruptcy.<sup>150</sup> Presently, the *priority rule* of section 9-310, giving certain possessory liens priority over prior perfected security interests, would not have to be changed. For example, a section could be drafted to provide that the *secured* creditor, who in the ordinary

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146. U.C.C. § 9-109(3) provides:

“[F]arm products” if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory.

This clearly includes such things as growing crops, harvested crops, animals, or milk.

147. See U.C.C. §§ 9-105(h), 9-109, 9-203(1), 9-402(1).

148. U.C.C. § 9-203. Of course, the creditor could file a civil action based on an unpaid debt. If a judgment is obtained, then a writ of execution could be obtained and executed, providing nonexempt property can be found. This is typically a more costly and time consuming process. It is also difficult to find unencumbered, nonexempt property. Also, if a lien is obtained within 90 days of filing bankruptcy, it can probably be avoided under 11 U.S.C. § 547(b) (1988).

149. Landlord liens are not covered because they are nonconsensual; however, nothing prevents the landlord from obtaining a perfected security interest. In fact, the landlord should obtain a perfected security interest because landlord liens are not enforceable in bankruptcy. 11 U.S.C. § 545(3). See also *supra* note 63 and accompanying text.

150. 11 U.S.C. § 545(3).

course of business furnishes labor, services, or materials that enhance or preserve the value of goods subject to a prior perfected security interest, will have priority over a prior perfected secured creditor. The creditor supplying the services would have to show that its security interest attached. This means, among other things, that there must be an agreement creating a security interest.<sup>151</sup> If the creditor has possession of the goods, the agreement need not be in writing.<sup>152</sup> Perfection can be established by possession.<sup>153</sup> If the creditor supplying the services does not have possession, it would have to obtain a written security agreement and file a financing statement in the appropriate place.

A provision would also have to be created for a landowner who must obtain a security interest in crops produced on his or her land to secure the promise to pay. This new section should make clear that a landowner who obtains a perfected security interest will have priority over a prior perfected security interest in the crops produced on the rented land. It seems appropriate to require the creditor who is being given a super-priority to file a financing statement within ten days before the service is supplied. Thus, a landlord would have to file within ten days of the debtor obtaining possession of the land.

This super-priority is consistent with the current treatment of purchase money security interests under sections 9-312(4)<sup>154</sup> and 9-312(3). New value is being added. The impact of these rules is illustrated by the following example. Assume a creditor had a perfected security interest in growing crops and the debtor hired a thresher to harvest the crops and then did not pay either. Under the proposed rules, if the thresher obtained a security interest and filed in a timely fashion, it would be prior to the creditor who perfected first. This seems equitable because the crops have more value harvested than in the field, and if the prior creditor had foreclosed while the crops were still in the ground it would have had to hire a thresher.

No doubt this proposed approach changes the rules for a thresher because many states have statutory thresher liens that give the thresher an enforceable lien by operation of law. Under the new rules, a thresher would have to obtain a written security agreement. Most creditors who are given liens by operation of law will object to obtaining an agreement creating a security interest. But why should these creditors be treated differently? Farming is a business, and those dealing with farmers should

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151. U.C.C. §§ 9-203(1)(a), 1-201(3).

152. *Id.* §§ 9-203(1), 1-201(3), 1-201(37). Clearly, it would be better practice to require a written security agreement.

153. *Id.* §§ 9-302(1)(a), 9-305.

154. See *supra* note 29.

be held to the same standards as other creditors. The handshake and notes on napkins are, or should be, things of the past.

Moreover, an agreement would make it clear what goods and what amount of money are involved. A thresher also would have to file a financing statement, which is presently required in many states. The thresher must file, unless he or she takes possession of the harvested crop, if he or she wants to be protected in bankruptcy.<sup>155</sup> Once a security interest is created, 7 U.S.C. § 1631 applies, but normally this will not be relevant. If it is, a thresher will probably be more protected than under current law. Many argue that it would place an expensive burden on these types of creditors. However, it seems that the cost would not be that great. The benefits to be gained are many. All creditors are subject to the same rules; everyone knows who has higher priority; a single scheme covers all creditors; public notice is given; and perfected secured creditors' interests cannot be avoided in bankruptcy. Of course, the thresher does not have to become a secured creditor. But the thresher should not complain when the farmer does not pay and files a bankruptcy petition.

This approach does not give a super-priority to suppliers of input needs such as feed, seed, fertilizer, chemicals, and fuel. These creditors are not enhancing or preserving the value of an *existing* good, but rather are financing the farmer's operation. They are selling, on credit, goods that help produce a product but are consumed, and do not remain a distinct, identifiable unit as is the case for creditors given special priorities under section 9-312(4). These inputs are not analogous to those considered inventory and, thus, subject to the super-priority rule of 9-312(3).<sup>156</sup>

Moreover, there is no justifiable reason to treat these types of financiers any differently than traditional banks or farm credit banks. Both are supplying credit for the same purpose. If the law were changed to give priority to input suppliers who perfect a security interest, it would seem that farmers would be able to get less credit. The traditional financier, such as a bank who loans a certain amount for input needs, would eliminate that portion of its funding. Otherwise, banks would be

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155. See 11 U.S.C. § 545(2) (1988).

156. See U.C.C. §§ 9-109(4), 9-312(3), 9-315. Cf. *First Nat'l Bank of Brush v. Bostron*, 39 Colo. App. 107, 564 P.2d 964, 966 (1977). The court was confronted with a perfected secured party's claim that its security interest in grain survived the grain being consumed by cattle in which the secured party had no interest. The secured party lost. The court, dealing with § 9-315, stated, "Cattle consume food as motor vehicles do gasoline. Once eaten the feed not only loses its identity, but in essence it ceases to exist and thus does not become part of the mass in the sense that the code uses the phrase." *Id.* See also *Farmers Cooperative Elevator Co. v. Union State Bank*, 409 N.W.2d 178 (Iowa 1987). But see *Mid-States Sales Co. v. Mountain Empire Dairymen's Ass'n, Inc.*, 741 P.2d 342 (Colo. App. 1987).

loaning money knowing that their farm product collateral may be shared with unknown other creditors having unknown amounts of credit that will have priority over the bank. The key here is that there is no way to know who might loan what amount after the general financier has made its evaluation and loan decisions. Moreover, input suppliers relying on state liens are apparently subject to a different rule if the farmer sells the crops to a purchaser and does not pay a supplier. The federal farm products rule does not apply to statutory liens, but does clearly apply to perfected security interests in crops.<sup>157</sup>

Currently, section 9-312(2) provides a very limited window of opportunity to second-in-line creditors. A perfected security interest in crops for new value is given a super-priority if 1) the purpose of the value is to enable the debtor to produce the crops during the current production season, 2) the value is given no more than three months before the crops become the growing crops, *and* 3) the obligation owing to the earlier secured party must have been *due* more than six months before the crops were planted. The principal issue concerns the meaning of the requirement that the previous obligation be "due more than six months." This requirement generally makes this section of limited value.<sup>158</sup> Some states have enacted statutory supplier's liens in an attempt to give the so-called input suppliers a super-priority. However, most of these statutes really do not change the law and only present a trap for the unwary.<sup>159</sup> Some farmers have complained bitterly that section 9-312(2) and broad after-acquired property clauses, coupled with the first to file rule, prevented them from receiving new financing. Unless a subordination is obtained or section 9-312(2) is applicable,<sup>160</sup> a perfected secured creditor having a proper security agreement covering after-acquired property will have a prior claim to any new crops produced, even if the creditor does not provide any new financing.

Interestingly, the prior secured creditor's after-acquired property clause is ineffective in bankruptcy if a debtor plants the crops within ninety days of bankruptcy.<sup>161</sup> However, it should be noted that a secured party's interest stems from the fact that a debtor still owed money. It is also interesting that farmers cannot be forced into bankruptcy involuntarily.<sup>162</sup>

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157. See *supra* text accompanying note 114.

158. See *supra* note 128.

159. See, e.g., IOWA CODE ANN. § 570A (West Supp. 1990); MINN. STAT. ANN. § 514.950 to .959 (West 1990), and § 514.945 (West Supp. 1991) (Agricultural Producer's Lien).

160. See *supra* text accompanying note 8.

161. 11 U.S.C. §§ 547(b)(4)(A), (e)(3)(f) (1988). See also § 552, which provides that an after-acquired property clause is ineffective relative to property obtained after the bankruptcy petition is filed. Proceeds are treated differently under § 552.

162. 11 U.S.C. § 303(a) (1988).

Unfortunately, not all farmers can or should be saved. Moreover, a complicated scheme should not be created just to save marginal farmers who have no realistic chance of saving their operation. However, one way to deal with these allegations that after-acquired clauses are too sinister is to go back to the approach of the 1962 Code, which provided that attachment could not occur unless the crops became growing crops within *one* year of execution of the security agreement.<sup>163</sup> This would be far superior to developing a complex statute to deal with the problem<sup>164</sup> or retaining the hodge podge of lien laws that exist today, or both. In any event, these input suppliers should be subject to the first to file rule.<sup>165</sup>

It appears inappropriate to try to protect unpaid producers under Article 9. As discussed earlier, unpaid producers currently are unable to protect themselves under Article 9.<sup>166</sup> The problem cannot be solved just by changing a priority rule. The only way to solve it under Article 9 would be to develop a rule similar to section 9-310, giving priority to any producer that had an enforceable lien under state or federal law. It is not appropriate to create a statutory lien in Article 9 just for producers. However, they need protecting because individually they have no way to protect themselves when the purchasers of goods will buy only on credit or with an ordinary check.<sup>167</sup> Although inconsistent with the general purpose of Article 9,<sup>168</sup> a priority lien could be given to the producers in Article 9. This lien would need to be perfected to be valid in bankruptcy.<sup>169</sup>

Producers clearly need some way to protect themselves. A number of possibilities exist. At the federal level, Congress already has provided protection for the unpaid sellers of livestock,<sup>170</sup> poultry,<sup>171</sup> and perishable commodities<sup>172</sup> by establishing a trust fund. Interestingly, grain and dairy product sellers are not covered. Congress could decide to mandate the same type of protection for grain and dairy sellers. Congress also could

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163. See U.C.C. § 9-204(4) (1962).

164. See Nickles, *Setting Farmers Free: Righting the Unintended Anomaly of UCC Section 9-312(2)*, 71 MINN. L. REV. 1135 (1987).

165. U.C.C. § 9-312(5)(a).

166. See *supra* text accompanying notes 124-28.

167. Most purchasers of farm products will not issue a cashiers check or certified check. Some states do require buyers, who buy on a delayed payment or delayed pricing contracts, upon the demand of the seller, to obtain an irrevocable standby letter of credit. KAN. STAT. ANN. § 34-2111 (1986).

168. See *supra* text accompanying notes 18-40.

169. See 11 U.S.C. § 545(2) (1988).

170. 7 U.S.C. § 196 (1988).

171. *Id.* § 197.

172. *Id.* § 499(c).

amend the Bankruptcy Code to provide *real* protections for unpaid sellers, unlike what it did for unpaid grain sellers in the 1984 amendments to the Bankruptcy Code.<sup>173</sup>

State protection is another option. One possible prototype is the California producer's lien which automatically arises upon delivery of the farm products. If the analysis of *Lorreto Winery*<sup>174</sup> is accepted by other courts, these secret liens will not be avoidable in bankruptcy. Clearly, it would be better to require producers to perfect their interest in some manner. This would provide notice, and perfected statutory liens are not subject to avoidance under section 545(2).<sup>175</sup> Some states have created so-called indemnity funds designed to reimburse producers of grain for losses sustained by buyer failure.<sup>176</sup> Private insurance was tried in Iowa and Minnesota but was dropped because of lack of interest, even though it was quite reasonable with a high deductible. Arguably, if farmers are not willing to purchase insurance, legislation should not be created to protect them. However, the stakes are high and it does not seem that producers should have to bear all of the risks or the costs connected with the risk of buyers and processors from failing.

#### CONCLUSION: A FEDERAL ARTICLE 9

Any serious evaluation of whether and how Article 9 should be changed should include consideration of whether Article 9 should be federalized. Certainly, a federal Article 9 would produce uniformity. A number of factors support a federal scheme. Today, many credit transactions involve multiple states and Article 9 is not uniformly followed. With the Bush administration currently pushing interstate banking, a federal UCC has greater appeal. Also, financial institution regulators are playing an increasingly bigger role in determining whether loans are classified as secured or unsecured for auditing purposes. The check collection process that was formerly governed by Article 4 of the UCC has been

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173. See 11 U.S.C. §§ 507(a)(5), 546(d), 557 (1988).

174. See *supra* text accompanying notes 91-114.

175. See *supra* text accompanying notes 91-122.

176. E.g., ILL. ANN. STAT. ch. 114, para. 701-12 (Smith Hurd 1988); IOWA CODE ANN. § 542 (West 1989); OKLA. STAT. ANN. tit. 9, § 41 (West 1989). These funds work basically in the same manner. The plan is funded by a monetary assessment levied upon each bushel of grain delivered to a grain dealer. When the fund reaches a certain level, no more assessments are made until the fund falls below the stated amount. The theory is that the fund should be adequate to fully compensate any farmer for losses sustained as a result of the failure of the grain dealer. The difficulty is that some of the funds only cover stored grain, not unpaid sellers who sell grain on a "price later" or deferred payment contract. Most cover sellers who receive bad checks. Many do not cover transactions involving federally licensed elevators.

almost totally preempted by The Expedited Funds Availability Act promulgated by Congress in 1988.<sup>177</sup> This Act empowered the Federal Reserve Board to promulgate regulations governing check collection. Thus, a federal agency controls this area, and the system seems to be working surprisingly well.<sup>178</sup> There are obvious problems with giving an agency this kind of power, but problems currently exist with the application of Article 9. These problems include: 1) a lack of uniformity regarding both provisions and interpretation; 2) the inability to change or fine-tune statutes quickly, and changes are made by people who have little or no understanding of Article 9 or the process; and 3) the lack of quick and consistent answers from the court process. Also, the regulations dealing with check collection are far superior to what many state legislatures have done and continue to do under Article 9. It must be remembered that Congress created a mess in 7 U.S.C. § 1631 (farm products rule). However, the difficulties of section 1631 are in large part explained by the fact that it was developed by an agricultural committee that apparently had no real understanding of Article 9. Federalizing Article 9 could cause more docket problems for the federal courts, but if a federal agency is involved, the number of cases reaching the federal courts should not be overwhelming. Finally, some have argued that if the UCC is revised to cover agricultural liens, there is a substantial risk that state legislatures will change fundamental Article 9 policies that have worked well in the nonagricultural areas in order to facilitate the protection of the family farmer.<sup>179</sup> These people apparently have no problem with a federal law dealing with liens on farm products because they are convinced that uniformity cannot be obtained at the state level.<sup>180</sup>

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177. 12 U.S.C. § 4001-4010 (1988). *See also* Regulation J, 12 C.F.R. pt. 210 (1990).

178. 12 U.S.C. §§ 4001-4010. For a thoughtful article about federalization of the UCC, see Rubin, *Uniformity, Regulation, and Federalization of State Law: Some Lessons from the Payment System*, 49 OHIO ST. L.J. 1251 (1989).

179. Letter from John D. Berchild, Jr. to David A. Lander (Mar. 18, 1991) (discussing Article 9 and agricultural liens). John Berchild is a partner in a large Los Angeles, CA law firm and a member of the ABA Committee considering whether Article 9 should be changed.

180. *Id.*

# Recent Developments in Chapter 12 Bankruptcy

SUSAN A. SCHNEIDER\*

## INTRODUCTION

This Article addresses some of the year's most important case law developments in the area of Chapter 12 bankruptcy.<sup>1</sup> These decisions document the continuing debate surrounding several fundamental aspects of farm reorganization under Chapter 12.

Enacted in October of 1986, Chapter 12 has existed for over four years.<sup>2</sup> Although this time period is sufficient to allow for substantial judicial interpretation, as this Article discusses, the circuits have failed to agree on several major issues. Even when there is agreement, a less than clear standard exists for the lower courts to follow. Thus, the controversy continues.

This Article highlights four issues that remain in dispute as evidenced by appellate cases<sup>3</sup> published in 1990. The first involves the fundamental issue of eligibility for Chapter 12 relief. The next three involve the powers afforded to the Chapter 12 debtor once eligibility is established. The issues discussed were chosen because of their overall significance in terms of their controversial nature and the level of judicial review afforded.<sup>4</sup>

### I. ELIGIBILITY FOR CHAPTER 12

Only a "family farmer with regular annual income" is eligible for Chapter 12 relief.<sup>5</sup> The term "family farmer" is defined in section 101(17)

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1. Chapter 12 is a special chapter of the United States Bankruptcy Code that establishes rules and procedures for debt reorganization of certain family farmers. 11 U.S.C. §§ 1201-1231 (1988).

2. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, tit. II, § 255, 100 Stat. 3105-3113 (1986).

3. Each of the primary cases discussed involves the review of a lower court decision. Four are circuit court opinions and one is a bankruptcy appellate panel decision.

4. This discussion is by no means intended, however, to indicate that the cases discussed were the only important decisions of the year. Many bankruptcy court decisions of significant impact were published and not appealed. Among other sources, THE FARMERS LEGAL ACTION REPORT contains a quarterly review and brief summary of all of the published bankruptcy decisions involving agriculture. This newsletter can be obtained from Farmers Legal Action Group, Inc., 1301 Minnesota Bldg., 46 E. 4th St., St. Paul, MN 55101.

5. 11 U.S.C. § 109(f) provides that "[o]nly a family farmer with regular annual income may be a debtor under chapter 12 of this title." 11 U.S.C. § 109(f) (1988).

of the Bankruptcy Code, with specific requirements for individuals<sup>6</sup> and similar, but distinct, requirements for partnerships and corporations.<sup>7</sup>

In general terms, section 101 requires that to qualify as a "family farmer," the debtor must be: engaged in farming; have debts below the maximum amount of total debt; have the requisite percentage of debt stem from the farming operation; have the requisite percentage of income arise from the farming operation; and if a partnership or corporation, meet the ownership and organization requirements.<sup>8</sup> These requirements address the issue of what constitutes farming from several different perspectives: the percentage of farm income; the percentage of farm debt; and the basic condition that the debtor be "engaged in farming." The "regular annual income" requirement is defined as annual income that is "sufficiently stable and regular to enable such family farmer to make payments" under a Chapter 12 plan.<sup>9</sup>

Because Chapter 12 offers significant powers to the debtor that may not be available under other bankruptcy chapters,<sup>10</sup> the issue of whether

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6. For individuals, § 101(17)(A) provides that a "family farmer" is (an) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed \$1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual's or such individual and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed.

11 U.S.C. § 101(17)(A) (1988).

7. For corporations and partnerships, § 101(17)(B) provides that a "family farmer" is

(a) corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and (i) more than 80 percent of the value of its assets consists of assets related to the farming operation; (ii) its aggregate debts do not exceed \$1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a farming operation), on the date the case is filed, arise out of the farming operation owned or operated by such corporation or such partnership; and (iii) if such corporation issues stock, such stock is not publicly traded.

11 U.S.C. § 101(17)(B) (1988).

8. *See supra* notes 6-7 and accompanying text.

9. 11 U.S.C. § 101(18) (1988).

10. For example, under Chapter 12 there is no "absolute priority rule" as exists

a debtor meets the specific eligibility requirements is frequently litigated.<sup>11</sup> Although the statute lists the specific amounts and percentages for debt and income requirements, the full range of activities that are to be considered "farming" remains uncertain. Because the definition of an activity as "farming" is determinative to the "engaged in farming" requirement and to several of the other eligibility requirements, the courts continue to struggle with the limits of what can be termed "farming." These struggles tend to focus on the concept of either farm income, farm debt, or the engaged in farming requirement itself.

There is no agreement on the test to be applied in addressing the areas noted above. Although admittedly there is a wide variety of types of family farms, this continuing controversy is somewhat surprising. The drafters of the Chapter 12 statutory language imposed specific guidelines. Moreover, "farming" is defined in the Bankruptcy Code. Section 101(18) provides that a "farming operation includes farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state."<sup>12</sup> However, litigation in this area continues to be prolific and highly contested.<sup>13</sup>

Admittedly, it would be impractical, if not impossible, to present a definition of farming that would precisely address each individual fact

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under Chapter 11. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). The "absolute priority rule," which prohibits the retention of any equity interest by the debtor over the interest of objecting creditors, has made Chapter 11 plans for family farm operations extremely difficult to confirm. *See* Norwest Bank of Worthington v. Ahlers, 485 U.S. 197 (1988) (defining the absolute priority rule as applied to farming operations). Similarly, creditors involved in a Chapter 12 bankruptcy do not have the § 1111(b) election that is available to creditors of Chapter 11 debtors. 11 U.S.C. § 1111(b) (1988).

11. In eligibility litigation, the debtor bears the burden of proof of establishing eligibility. *See, e.g.*, *In re Tim Wargo & Sons, Inc.*, 869 F.2d 1128 (8th Cir. 1989).

12. 11 U.S.C. § 101(20) (1988).

13. In 1990, the following reported cases addressed eligibility for Chapter 12 relief and the definition of "farming": *In re Watford*, 898 F.2d 1525 (11th Cir. 1990) (stone crabbing is not a "farming operation," but storing soybeans and the intent to establish catfish ponds may be; *infra* note 19 and accompanying text); *In re Smith*, 109 Bankr. 241 (W.D. Ky. 1989) (insurance proceeds from the destruction of a combine by fire do not constitute income from a "farming operation"); *In re Way*, 120 Bankr. 81 (Bankr. S.D. Tex. 1990) (nontaxable government agricultural subsidy payments qualify as "farm income" but director's fees from farming corporation do not); *In re Easton*, 118 Bankr. 676 (Bankr. N.D. Iowa 1990) (on remand from 8th Circuit, cash rental income found to be income from farming operation because debtors had a "significant degree of engagement in" and a "significant operational role in" the production of crops on the rented land; same test is used to qualify debt on hog facility as debt arising from the debtors' farming operation); *In re Marlatt*, 116 Bankr. 703 (Bankr. D. Neb. 1990) (debt owed to former spouse arising out of property settlement that awarded farming operation to debtor constitutes debt arising out of the farming operation); *In re Richardson*, 113 Bankr. 28 (Bankr. D. Colo. 1990) (contract crop spraying income is not farm income).

situation. The listing of farming activities contained in section 101 is not all inclusive.<sup>14</sup> Thus, the issue is what test a court should apply in determining whether an activity is a "farming" activity.

Much of the current litigation on this subject references the 1987 Seventh Circuit decision in *In re Armstrong*.<sup>15</sup> The *Armstrong* decision required an interpretation of the definition of farm income under the general Bankruptcy Code requirements. *Armstrong* involved the issue of protection afforded farmers from involuntary bankruptcy. However, because both this protection and Chapter 12 eligibility rely in part on a determination of what constitutes farm income, Chapter 12 cases generally have either relied upon or dissented from *Armstrong* on a variety of eligibility issues.

*Armstrong* is a particularly well-suited example of the disagreement that marks the interpretation of Chapter 12 requirements. Although *Armstrong* touches on many areas, and is discussed by other courts in a variety of contexts, the primary issue in *Armstrong* was the categorization of cash rental income paid to the lessor of farmland. The majority held that for income to be categorized as farm income, it must meet what is termed the "risk test."<sup>16</sup> Its receipt must be dependent upon the risk inherent in traditional farming operations. If it is not, as in the case of cash rent for leased farmland, it is not farm income. The dissent rejected this mechanical approach and proposed a totality of the circumstances test.<sup>17</sup> Under the dissent's approach, the debtor's overall situation could be examined and an equitable result reached. After *Armstrong*, many lower courts have lined up on one side or the other, with the majority of courts appearing to reject the *Armstrong* risk test.<sup>18</sup>

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14. The Rules of Construction section of the Bankruptcy Code, § 102, confirms that the term "includes" as used in the § 101 listing is not to be read as a limitation. 11 U.S.C. § 102(3) (1988).

15. 812 F.2d 1024 (7th Cir.), *cert. denied*, 484 U.S. 925 (1987).

16. *Id.* at 1027.

17. *Id.* at 1030.

18. Cases following the majority's approach in *Armstrong* include *In re Krueger*, 104 Bankr. 223 (Bankr. D. Neb. 1988); *In re Maschhoff*, 89 Bankr. 768 (Bankr. S.D. Ill. 1988); *In re Seabloom*, 78 Bankr. 543 (Bankr. C.D. Ill. 1987); *In re Haschke*, 77 Bankr. 223 (Bankr. D. Neb. 1987). Cases that have rejected the *Armstrong* majority include *In re Vernon*, 101 Bankr. 87 (Bankr. E.D. Mo. 1989); *In re Coulston*, 98 Bankr. 280 (Bankr. E.D. Mich. 1989); *In re Hettinger*, 95 Bankr. 110 (Bankr. E.D. Mo. 1989); *In re Jessen*, 82 Bankr. 490 (Bankr. S.D. Iowa 1988); *In re Burke*, 81 Bankr. 971 (Bankr. S.D. Iowa 1987); *In re Rott*, 73 Bankr. 366 (Bankr. D.N.D. 1987). Note that subsequent to the opinions referenced above, the Eighth Circuit rejected both the majority and the minority *Armstrong* opinions, declaring a new test for the farm income determination. *In re Easton*, 883 F.2d 630 (8th Cir. 1989). For a discussion of *Easton* and the Eighth

The debate continued this year with the Eleventh Circuit decision on Chapter 12 eligibility in the case of *In re Watford*.<sup>19</sup> Three activities were presented as potential farming activities: stone crabbing, the storing of soybeans, and the debtor's future plans to establish catfish ponds. The debtors, who previously raised soybeans in a more traditional farming operation, had stored their last soybean crop and had let the land lay idle while they conducted a stone crabbing business in the Gulf of Mexico. However, the debtors testified that they intended to build commercial fishponds on the farm. The court was asked to determine whether the debtors were engaged in a farming operation for purposes of Chapter 12 eligibility.

Before evaluating the debtors' activities, the court acknowledged that a debtor must be "engaged in farming" at the time that the Chapter 12 petition is filed.<sup>20</sup> Two separate issues were presented — whether the activities in question could be considered farming activities and whether the debtors' future intentions were sufficient to meet the requirement that the debtor be engaged in farming at the time of filing.

On the first issue, the court held that the debtors' stone crabbing business did not constitute a farming operation. The court found it "too remote from Congress' statutory purpose."<sup>21</sup>

Similarly, the court held that the storage of soybeans alone did not indicate a "farming operation."<sup>22</sup> However, the court stated that this storage, if part of a "continuing farm effort," would be sufficient to render the debtor eligible for Chapter 12 relief.<sup>23</sup>

The distinction is based on the debtor's intentions. According to *Watford*, if at the time of filing, the debtor has abandoned farming, the continued storage is immaterial. The Chapter 12 petition must be dismissed. If, on the other hand, the debtor has an ongoing farming operation or "plans the reorganization of the farming operation," the farmer is "engaged in farming" for purposes of Chapter 12 eligibility.<sup>24</sup>

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Circuit's treatment of Chapter 12 eligibility issues, see Note, *Get Down and Dirty: The Eighth Circuit's Admonition to Farmers Seeking the Protection of Chapter 12*, 43 ARK. L. REV. 701 (1990).

19. 898 F.2d 1525 (11th Cir. 1990).

20. *Id.* at 1527 (citing *In re Paul*, 83 Bankr. 709, 712 (Bankr. D.N.D. 1988); *In re Haschke*, 77 Bankr. 223, 225 (Bankr. D. Neb. 1987); *In re Mikkelson*, 74 Bankr. 280, 284 (Bankr. D. Or. 1987); *In re Tart*, 73 Bankr. 78, 81 (Bankr. E.D.N.C. 1987); 2 COLLIER ON BANKRUPTCY 101-55 (L. King 15th ed. 1989)).

21. *Watford*, 898 F.2d at 1527. Although the court does not explain what its interpretation of "Congress's statutory purpose" is, it appears to be referring to the protection of the traditional family farmer that is engaged in crop or livestock farming.

22. *Id.* (citing *In re Haschke*, 77 Bankr. 223, 225 (Bankr. D. Neb. 1987)).

23. *Id.*

24. *Id.* at 1528.

Applying this reasoning to the debtors' plans to construct commercial fish ponds on the farm, the *Watford* court held that it is the debtor's intentions at the time of filing that controls. The debtor need not be engaged in the activity as of filing, so long as the intention to farm exists. Because the lower courts found the Watfords' intention to catfish farm irrelevant, the case was remanded on this point.<sup>25</sup>

In so holding, the court relied upon the reasoning set forth in the *Armstrong* dissent, and cited similar lower court holdings.<sup>26</sup> It explicitly rejected what it termed the "contrary implication" in footnote 2 of the majority opinion in *Armstrong*.<sup>27</sup> Addressing the *Armstrong* court's concern that focusing on the debtor's intentions would encourage deceit, the *Watford* court noted that "distinguishing truths and untruths is an inherent function of the courts."<sup>28</sup>

Citing the intention of Congress in enacting Chapter 12, the court adopted a totality of the circumstances test. Again rejecting the majority opinion in *Armstrong*, the *Watford* court stated that on remand the proper question for the bankruptcy court must be "whether under the totality of the circumstances the Watfords had abandoned all farming operations, but rather were planning to continue farming operations in the form of commercial fish ponds or otherwise."<sup>29</sup>

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25. *Id.* at 1528-29.

26. *Id.* (citing *Armstrong*, 812 F.2d at 1031 (Cudahy, J., dissenting); *In re Coulston*, 98 Bankr. 280, 281, 284 (Bankr. E. D. Mich. 1989); *In re Hettinger*, 95 Bankr. 110, 112 (Bankr. E.D. Mo. 1989); *In re Paul*, 83 Bankr. 709, 713 (Bankr. D.N.D. 1988); *In re Burke*, 81 Bankr. 971, 976-977 (Bankr. S.D. Iowa 1987); *In re Sugar Pine Ranch*, 100 Bankr. 28 (Bankr. D. Or. 1989); *In re Maike*, 77 Bankr. 832, 835 (Bankr. D. Kan. 1987); *In re Mikkelsen Farms*, 74 Bankr. 280, 284 (Bankr. D. Or. 1987)). *But see In re Cluck*, 101 Bankr. 691 (Bankr. E.D. Okla. 1989).

27. Footnote 2 from the *Armstrong* opinion includes the majority's criticism of the dissent's consideration of the debtors' future intentions. It provides in relevant part, [T]he dissent would have a court try to grapple with the issue of a farmer's future intent. The results of such fact-finding would be haphazard and unfocused. Most farmers would say that their intention would be to farm the rented acreage in the future. After all, what would there be to lose? Indeed, a farmer could be sincere in saying this but be unrealistic in his estimation of his chances. Conceivably, a farmer could rent the land for a few years — each year telling the court (at yet another hearing) he was closer to solvency, closer to tilling. Of course, some farmers would inevitably be bluffing — deceiving the court while playing landlord. The dissent suggests courts look for, the first year of [a] lease, that the farm was financially troubled, . . . participat[ion] in actually operating the farm. This criteria is more vague than it sounds. It arguably would issue a blank check for one year to any farmer who wants to lease instead of till — as long as he demonstrates he operated at a loss the year before and indicates an "intent" to let the lease expire.

*Armstrong*, 812 F.2d at 1028 n.2.

28. *Watford*, 898 F.2d at 1529 (citing *Coulston*, 98 Bankr. at 281 n.1).

29. *Id.*

## II. POWERS AVAILABLE TO CHAPTER 12 DEBTORS

### A. *Contract for Deed*

Another ongoing controversy involves the classification of a contract for deed or land sale contract. Although in many instances both vendor and vendee will think of this contract as a simplified mortgage transaction, in the context of bankruptcy it may be treated very differently. The controversy is whether this type of contract should be treated as a mortgage transaction, characterizing the vendor as a lienholder, or whether the contract should be treated as an executory contract under section 365 of the Bankruptcy Code. If it is treated as an executory contract, the debtor's rights to modify that contract are severely limited, generally allowing only the opportunity to affirm or reject the contract as written.<sup>30</sup>

The Sixth Circuit recently addressed this issue in the context of a Chapter 12 reorganization in *In re Terrell*.<sup>31</sup> At issue in *Terrell* was whether the debtors' obligations under a land sale contract could be altered pursuant to section 1225, the "cram down" provision of Chapter 12 reorganization.<sup>32</sup> The "cram down" provision allows a debtor to adjust an obligation owed to a secured creditor without the consent of that creditor, provided that certain guidelines are met.<sup>33</sup> Although this provision is clearly applicable to mortgages and other secured transactions, in *Terrell* the vendor challenged its application to the land sale contract at issue.

In reaching its decision, the court confronted the somewhat confusing interaction of federal and state law with regard to executory contract determination. Accepting the Ninth Circuit's characterization of this interaction, *Terrell* found a combined role for federal and state law in determining whether the contract was executory for purposes of section 365.<sup>34</sup> Federal law provides the definition of the term "executory con-

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30. 11 U.S.C. § 365 (1988).

31. 892 F.2d 469 (6th Cir. 1989).

32. 11 U.S.C. § 1225 (1990).

33. *Id.* § 1225(a)(5). The plan confirmation standards set forth in § 1225(a)(5) require that the secured creditor either consent to the plan, retain its lien and receive value not less than the amount of its secured claim, or that the debtor surrender the security property to the claim holder. Under § 506, the value of the secured claim can be reduced to the value of the collateral. As such, a debtor is allowed to reduce a secured obligation to the amount of the secured claim, *i.e.*, the value of the collateral. Applying this to the facts in *Terrell*, the debtors hoped to reduce the amount owed on their land sale contract by confirmation of a reorganization plan that paid only the market value of the property, the amount of the creditor's secured claim.

34. *Terrell*, 892 F.2d at 471-72 (citing *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1348 n.4 (9th Cir. 1983)). See also *In re Streets and Beard Farm Partnership*, 882 F.2d 233, 235 (7th Cir. 1989).

tract.”<sup>35</sup> State law provides the standard for evaluating the parties’ legal obligations under the contract. These state law obligations are then analyzed to see if the contract meets the federal definition.<sup>36</sup>

Referring first to the federal definition of executory contract, *Terrell* acknowledged that the Bankruptcy Code itself provides little assistance.<sup>37</sup> The term “executory contract” is not defined in the Bankruptcy Code. The legislative history, however, refers to an executory contract as one “on which performance remains due to some extent on both sides.”<sup>38</sup> Moreover, there is general acceptance of the definition provided by Professor Countryman in the article entitled *Executory Contracts in Bankruptcy: Part I*.<sup>39</sup> Countryman defined an executory contract as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>40</sup> Accepting this definition as the federal standard, *Terrell* focused on the concept of obligations that, if unperformed, would give rise to a material breach excusing the other party from performance.<sup>41</sup>

From this definition of executory contract, the *Terrell* court turned its focus to Michigan state law and the obligations of the parties to the land sale contract at issue. Specifically, the court examined whether one party’s failure to perform under the contract would constitute a material breach that would excuse the other parties’ performance.<sup>42</sup>

This approach to the application of state law is the most controversial aspect of the *Terrell* opinion. The court did not defer to state law decisions characterizing a land sale contract as akin to a purchase money mortgage. In previous cases involving land sale contracts, both the Michigan Court of Appeals and the Michigan Supreme Court have held

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35. *Terrell* at 471-72.

36. *Id.*

37. *Id.*

38. *Terrell*, 892 F.2d at 471 (citing S. REP. NO. 95-989, 95th Cong. 2d Sess. 58, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5844; H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 347, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5963, 6303).

39. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). *Terrell* states that this article provides the definition that Congress “apparently had in mind” with regard to § 365 and cites to Ninth and Eighth Circuit opinions referencing it. *Terrell*, 892 F.2d at 471 (citing *In re Select-A-Seat Corp.*, 625 F.2d 290, 292 (9th Cir. 1980) (per curium) (quoting *Jenson v. Continental Fin. Corp.*, 591 F.2d 477, 481 (8th Cir. 1979)).

40. Countryman at 460.

41. *Terrell*, 892 F.2d at 471-72.

42. *Id.* at 472.

that under such contracts, the vendor holds legal title only as security for payment of the contract obligations. Thus, the contract was found to be analogous to a mortgage.<sup>43</sup>

Instead, *Terrell* discounted the state courts' characterization, and chose to be guided by its own interpretation of the parties' obligations under the contract. It maintained that the state courts' characterizations of the nature of the vendor and vendee's interests were not determinative because they did not specifically focus on the nature of the unperformed obligations.<sup>44</sup> The court found that according to the terms of the land sale contract, the Terrells were obligated to make payments for several years while the vendor remained obligated to surrender legal title. Because of the presence of these mutual, unperformed obligations, the court found that "[u]nder a land sale contract, unlike most mortgages, 'performance remains due to some extent on both sides' and the failure of either party to fulfill his or her obligations would excuse the other from continued performance."<sup>45</sup> Based on this finding, the court held that section 365 controlled and that the Terrells were thus precluded from reorganizing the contract terms under the section 1225 powers.<sup>46</sup>

The *Terrell* opinion acknowledged that the Seventh Circuit adopted a contrary position in *In re Streets & Beard Farm Partnership*.<sup>47</sup> *Streets & Beard* also applied the Countryman definition of an executory contract.<sup>48</sup> However, the court found that the land contract at issue was not an executory contract. It held that the vendor's obligation to deliver legal title to the vendee was a "mere formality" and that it did not "represent the kind of significant legal obligation that would render the contract executory."<sup>49</sup> The court then concluded that the arrangement between the vendor and the vendee was "a security agreement where the vendor holds legal title in trust solely as security for the payment of the purchase price."<sup>50</sup> The court held that because security agreements

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43. *Barker v. Klingler*, 302 Mich. 282, 4 N.W.2d 596 (1942)(vendor holds legal title only as security for the payment of the purchase price); *Rothenberg v. Follman*, 19 Mich. App. 383, 387 n.4, 172 N.W.2d 845, 847 n.4 (1969)(no functional difference exists between a purchase money mortgage and a land contract). Similarly, the bankruptcy court from the Eastern District of Michigan held that a land contract was not an executory contract under § 365. *In re Britton*, 43 Bankr. 605 (Bankr. E.D. Mich. 1984). The *Britton* decision was expressly overruled by *Terrell*. *Terrell*, 892 F.2d at 472.

44. *Terrell*, 892 F.2d at 472.

45. *Id.* at 473.

46. *Id.*

47. 882 F.2d 233 (7th Cir. 1989).

48. See *supra* note 39 and accompanying text.

49. *Streets & Beard*, 882 F.2d at 235.

50. *Id.*

are not executory contracts under the Bankruptcy Code, neither was the contract at issue.<sup>51</sup>

In commenting on *Streets & Beard*, the *Terrell* court noted that it could not "pass judgment" on the significance of a vendor's obligations under Illinois law, but that under Michigan law, a vendor's failure to deliver title would "excuse the vendee's performance and give rise to an action for rescission or specific performance."<sup>52</sup> It is likely that the Seventh Circuit would respond that this broad interpretation of executory contract is contrary to the intent of Congress. The Seventh Circuit stated in *Streets & Beard* that it believed that "Congress intended section 365 to apply to contracts where *significant* unperformed obligations remain on both sides."<sup>53</sup> It appears that the two courts differ as to the significance of delivery of legal title, and the split in the circuits remains.<sup>54</sup>

### *B. Bankruptcy and the Agricultural Credit Act of 1987*

A special category of bankruptcy cases involves the interaction of bankruptcy law and the Agricultural Credit Act of 1987 (hereafter the Act).<sup>55</sup> The Act established debt restructuring programs for Farm Credit System (hereafter FCS) and Farmers Home Administration (hereafter FmHA) borrowers. The bankruptcy cases thereunder generally involve the debtors' attempts to use the protections promised them under the Act while in bankruptcy. With regard to FCS borrowers, numerous cases have held that the FCS lender must comply with the requirements set forth in the Act prior either to obtaining relief from the automatic stay

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51. *Id.* (citing *In re Pacific Exp., Inc.*, 780 F.2d 1482, 1487 (9th Cir. 1986) for the proposition that security agreements are not executory contracts under § 365 of the Bankruptcy Code).

52. *Terrell*, 892 F.2d at 472-473 n.6.

53. *Streets & Beard*, 882 F.2d at 235 (emphasis added).

54. Although not cited in *Terrell*, the Eighth Circuit has also held that a contract for deed is executory, applying Iowa and South Dakota law. *In re Speck*, 798 F.2d 279 (8th Cir. 1986) (applying South Dakota law); *Brown v. First National Bank in Lenox*, 844 F.2d 580 (8th Cir. 1988) (applying Iowa law). In circuits where there has not been an appellate level decision, the bankruptcy courts are split. *Compare In re Anderson*, 36 Bankr. 120 (Bankr. D. Haw. 1983); *Shaw v. Dawson*, 48 Bankr. 857 (Bankr. D.N.M. 1985); *In re Aslan*, 65 Bankr. 826 (Bankr. C.D. Cal. 1986) (viewing land contracts as executory) with *In re Booth*, 19 Bankr. 53 (Bankr. D. Utah 1982); *In re Kratz*, 96 Bankr. 127 (Bankr. S.D. Ohio 1988); *In re Sennhenn*, 80 Bankr. 89 (Bankr. N.D. Ohio 1987) (treating the contract as a security device). As noted, *supra* note 40, before the *Terrell* decision, a bankruptcy court within the Sixth Circuit held that a land contract was not executory. *In re Britton*, 43 Bankr. 605 (Bankr. E.D. Mich. 1984). *Terrell* overruled this decision. *Terrell*, 892 F.2d at 472.

55. Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 568 (1988) (codified in scattered sections of 7 & 12 U.S.C.).

or taking adverse action against the debtor.<sup>56</sup> Note that these cases do not mandate restructuring, only consideration for restructuring.<sup>57</sup>

FCS debtors have been less successful in attempting to use the Act to reduce the value of secured debt in bankruptcy. In some cases they argued that the valuation of the collateral should be based upon its liquidation value under the FCS cost of restructuring/cost of foreclosure analysis.<sup>58</sup> However, FCS borrowers failed to obtain this reduction in several bankruptcy reorganizations. In those instances, the bankruptcy courts held that valuation should be the fair market value of the collateral, based only upon the bankruptcy standards set forth in section 506 of the Bankruptcy Code and the case law interpreting it.<sup>59</sup>

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56. *Hill v. Farm Credit Bank of St. Louis*, 726 F. Supp. 1201, 1205 (E.D. Mo. 1989) (Congress did not intend to exclude debtors in bankruptcy from the protections of the Act); *In re Jarrett Ranches, Inc.*, 107 Bankr. 969 (Bankr. D.S.D. 1989) (FCS lender required to sell property according to borrower protections set forth in the Act); *In re Kramer*, 107 Bankr. 668, 670 (Bankr. D. Neb. 1989) (order for sequestration of rents and profits cannot be obtained prior to compliance with the Act); *In re Rudloff*, 107 Bankr. 663, 665 (Bankr. D. Neb. 1989) (determination of distressed loan status required prior to sending restructuring notice; relief from stay not granted prior to compliance with Act); *In re Wagner*, 107 Bankr. 662, 663 (Bankr. D. Neb. 1989) (determination of distressed loan status required prior to offering restructuring opportunity; relief from stay denied due to failure to comply with Act); *In re Dilsaver*, 86 Bankr. 1010, 1015 (Bankr. D. Neb. 1988), *aff'd sub nom. In re Hilton Land & Cattle Co.*, 101 Bankr. 604, 606 (D. Neb. 1989) (compliance with Act required prior to sequestration of rents and profits); *Stainback v. Federal Land Bank of Jackson*, No. GC880 (N.D. Miss. Feb. 8, 1988) (temporary restraining order issued to enjoin foreclosure sale; borrower and FCS lender directed to engage in restructuring discussions under the Act). Note that these cases do not deal with the issue of whether an implied cause of action exists under the Act. Three circuit courts have found that an implied cause of action does not exist. *Zajac v. Federal Land Bank of St. Paul*, 909 F.2d 1181 (8th Cir. 1990) (en banc); *Griffin v. Federal Land Bank of Wichita*, 902 F.2d 22 (10th Cir. 1990); *Harper v. Federal Land Bank of Spokane*, 878 F.2d 1172 (9th Cir. 1989), *cert. denied*, 110 S. Ct. 867 (1990). *But cf. Payne v. Federal Land Bank of Columbia*, 916 F.2d 179 (4th Cir. 1990) (granting relief to the borrower to remedy violations of the Act without addressing implied cause of action issue). For an excellent discussion of Farm Credit System borrowers' rights, including an analysis of the implied cause of action issue, see *Kelley & Hoekstra, A Guide to Borrower Litigation Against the Farm Credit System and the Rights of Farm Credit System Borrowers*, 66 N.D.L. REV. 129 (1990).

57. The Act requires Farm Credit System lenders to consider borrowers with distressed loans for restructuring, and prescribes a basic format for this consideration, but does not mandate that a given loan be restructured. See *In re Bellman Farms, Inc.*, 86 Bankr. 1016 (Bankr. D.S.D. 1988). See also *Kelley & Hoekstra, supra* note 56, at 191-213 (providing a detailed analysis of the restructuring procedure under the Act).

58. See, e.g., *In re Bellman Farms Inc.*, 86 Bankr. 1016, 1022 (Bankr. D.S.D. 1988).

59. See *In re Felton*, 95 Bankr. 629 (Bankr. N.D. Iowa 1988) (provisions of the Act are not to be incorporated into the Bankruptcy Code and are inapplicable to valuation

The Ninth Circuit Bankruptcy Appellate Panel addressed this valuation issue with regard to FmHA borrowers in bankruptcy in the recent case of *In re Case*.<sup>60</sup> In *Case*, the court held that in determining the value of FmHA's secured claim and the proper rate of interest to be paid on FmHA debt,<sup>61</sup> the provisions of the Act did not apply.<sup>62</sup> The court held that the collateral should be valued according to its fair market value.<sup>63</sup> Several inexplicable flaws in the court's analysis, however, may well affect the precedential value of its decision.

Throughout the *Case* opinion, the court erroneously cited to the statutory provisions of the Act that apply to FCS. These are completely different from the applicable provisions of the Act that apply to the lender at issue, FmHA. Indeed, although the FCS and FmHA restructuring programs may be similar in the underlying congressional intent, different requirements apply to each lender, and these requirements are now codified in different titles of the U.S. Code.<sup>64</sup>

With regard to FCS, restructuring determinations are based upon what the Act terms "cost of restructuring"<sup>65</sup> and "cost of foreclosure."<sup>66</sup> As has been noted, these terms, defined in the Act, have generated a certain amount of confusion as to what FCS lenders are required to consider, causing system lenders to devise different formulas to compute these costs and evaluate restructuring applications.<sup>67</sup>

In contrast, a separate section of the Act sets up different procedures for FmHA to follow in reviewing its troubled loans. The FmHA procedure relies upon what the Act terms "net recovery value"<sup>68</sup> instead of cost

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of FCS lender's secured claim); *In re Bellman Farms, Inc.*, 86 Bankr. 1016 (Bankr. D.S.D. 1988) (Act does not affect § 506(a) valuation of FCS lender's secured claim); *In re Kraus*, No. BK 86-2677, slip op. at 2 (Bankr. D. Neb. May 20, 1988) (Act does not affect confirmed Chapter 11 plan); *In re Pennington*, No. 87-01485-BKC-DTW, slip op. at 2 (Bankr. N.D. Miss. March 22, 1988) (Act does not affect § 506(a) valuation). See also Kelley & Hoekstra, *supra* note 56 at 191-92, n.365 (discussing FCS borrowers' rights in bankruptcy).

60. 115 Bankr. 666 (Bankr. 9th Cir. 1990).

61. The portions of *Case* that deal with interest rate considerations are discussed *infra* at notes 82, 98-101 and accompanying text.

62. *Case*, 115 Bankr. at 669.

63. *Id.* at 669-70.

64. Provisions of the Act that apply to FCS are codified in scattered sections of title 12 U.S.C. and those applicable to FmHA are codified at title 7 U.S.C.

65. 12 U.S.C. § 2202a(e)(2) (1988); 12 C.F.R. § 614.4517(a) (1990).

66. 12 U.S.C. § 2202a(a)(2)(1988); 12 C.F.R. § 614.4512(c) (1990).

67. See Kelley & Hoekstra, *supra* note 56, at 191-99.

68. 7 U.S.C. §2001(c)(2) (1988). For a complete analysis of FmHA's loan servicing programs, including the debt restructuring provisions mandated by the Agricultural Credit Act, see ROTH, *FARMERS GUIDE TO FMHA* (4th ed. 1990) (available through Farmers Legal Action Group, Inc., 1301 Minnesota Bldg, 46 E. 4th St., St. Paul, MN 55101.).

of restructuring and cost of foreclosure. The precise procedure to be followed in computing this amount and in applying it to a borrower's individual situation is set forth with far more specificity than is found in the FCS portion of the Act. Although the amounts inserted may vary, the statute requires that specific deductions from the fair market value of the collateral be made in computing FmHA's net recovery value.<sup>69</sup>

In reviewing *Case*, it is apparent that the court was not just careless in its citation; it was also careless in its analysis. The court discussed the restructuring process, clearly describing the FCS process instead of the FmHA process. After this discussion, the court concluded, "[a]s is defined by the Act 'cost of foreclosure' is intended to be nothing more than a threshold upon which to determine whether a particular restructuring proposal is economically feasible."<sup>70</sup> In support of its conclusion, the court then cited *In re Bellman Farms*, a case involving an FCS borrower. The court added, "The Act does not mandate the restructuring of a debt at the liquidation value of the collateral, and in fact does not set forth a calculation for the amount of the restructured debt."<sup>71</sup> Although this statement would be accurate if applied to FCS, it is erroneous when applied to FmHA, the lender at issue.

The court, however, does provide support for its decision that is not marred by its confusion about the applicable federal statutes. It asserted that the bankruptcy courts are not bound by the Act and that the remedies available thereunder are "separate and distinct remedies from the remedial protection afforded to farm debtors under Chapter 12."<sup>72</sup> On this basis, the court turned exclusively to an analysis of bankruptcy law in determining the amount of FmHA's secured claim. Under section 1225, absent creditor consent, the debtor's plan must offer the holder of each secured claim value "not less than the allowed amount of such claim."<sup>73</sup> In order to determine whether this "value" has been provided, the amount of the allowed secured claim must be established.<sup>74</sup> Section 506 of the Bankruptcy Code provides the guidelines for setting

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69. 7 U.S.C. § 1981 (1981); 7 C.F.R. § 1951.909(f) (1990).

70. *Case*, 115 Bankr. at 669.

71. *Id.*

72. *Id.* (citing *In re Felton*, 95 Bankr. 629, 630 (Bankr. N.D. Iowa 1988) (involving FCS restructuring provisions under the Act)). In one of the few bankruptcy cases involving FmHA provisions under the Act, *In re Kvamme* held that restructuring under the Act was not the only remedy available to FmHA and that it was entitled to exercise its § 1111(b) election in Chapter 11. *In re Kvamme*, 91 Bankr. 77 (Bankr. D.N.D. 1988). *Kvamme* is not cited in *Case*.

73. 11 U.S.C. § 1225(a)(5)(B)(ii) (1988) discussed in *Case*, 115 Bankr. at 669.

74. *Case*, 115 Bankr. at 669.

this amount.<sup>75</sup> It provides in part that an allowed claim is a secured claim "to the extent of the value of such creditor's interest . . . in such property" and that "such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."<sup>76</sup> Interpreting these provisions and the purpose for which valuation is sought, *Case* states that because the debtor seeks to retain the property, deductions from fair market value are inappropriate.<sup>77</sup>

The court noted that if the purpose for the evaluation was different, such as if adequate protection were at issue, the deduction of liquidation expenses might be appropriate. For section 1225 purposes, however, the court held that the fair market value of the property was the amount that FmHA must receive as value under the terms of the plan.<sup>78</sup>

In light of the court's explanation of valuation under the Bankruptcy Code, it is unfortunate that the court did not follow the proper restructuring provisions applicable to FmHA. It can be argued that these provisions, far more specific than those applicable to FCS, which define in detail the recovery rights of FmHA, restrict the "value" of FmHA's claim under section 506. If under the statutes that govern FmHA, the property is not entitled to receive full fair market value, arguably the "value of such creditor's interest . . . in such property" under section 506 should be similarly limited. Unfortunately, *Case* does not address this important issue.

### C. Interest Rate

Once the value of the secured claim is established, the next debate concerns the modification of the terms of the debtor's secured loans.

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75. 11 U.S.C. § 506(a) (1988) discussed in *Case*, 115 Bankr. at 669.

76. *Id.*

77. *Case*, 115 Bankr. at 669 (citing *In re Felten*, 95 Bankr. 629, 630 (Bankr. N.D. Iowa 1988); *In re Anderson*, 88 Bankr. 877, 885-86 (Bankr. N.D. Ind. 1988); *In re Bellman Farms, Inc.*, 86 Bankr. 1016, 1019 (Bankr. D.S.D. 1988); *In re Foster*, 79 Bankr. 906, 907 (Bankr. D. Mont. 1987); *In re Snider Farms, Inc.*, 79 Bankr. 801, 811 (Bankr. N.D. Ind. 1987); *In re Danelson*, 77 Bankr. 261, 263 (Bankr. D. Mont. 1987); *In re Robinson Ranch Inc.*, 75 Bankr. 606, 608 (Bankr. D. Mont. 1987) (for the proposition that when a debtor retains the collateral, fair market value, without deduction for cost of sale, is the appropriate valuation). Note, however, that in the usual context, deductions for liquidation costs are not made when the debtor retains possession of the collateral because a liquidation sale will not be held. Thus, the value ascribed to the collateral reflects the debtor's continued possession of the property. Liquidation sale costs are not deducted, in part because such costs will presumably not be incurred. In contrast, under the requirements of the Act, deductions based on FmHA's hypothetical liquidation costs are required even though the property will remain in the possession of the debtor. See *Roth*, *supra* note 68.

78. *Case*, 115 Bankr. at 670.

Chapter 12 allows the debtor to alter these loan terms to provide for an extended payment period and/or an adjusted interest rate.<sup>79</sup> As discussed previously, however, Chapter 12 plan confirmation standards require that the secured claim holders receive the full value of the allowed amount of their secured claim.<sup>80</sup> Thus, if payments are stretched out over a period of time, the creditor must receive the "present value" of its claim. Payments are "discounted" to reflect the receipt of the funds in the future. The basic concept is:

When the debtor's plan proposes to pay a secured claim in deferred cash installments, the court must find that the present value of the proposed payments is not less than the allowed amount of the secured claim. In order to make this finding, it will be necessary for the court to apply a discount factor to the proposed stream of payments to determine the present value of those payments. This is typically accomplished by ascribing an interest rate to the allowed amount of the claim and by requiring payment of the amount of the claim along with interest at the specified rate.<sup>81</sup>

The rate of interest to be paid is a much litigated aspect of Chapter 12 reorganization. The resulting case law generally has established that, with the exception of FmHA loans, a "market" rate of interest is appropriate.<sup>82</sup> However, there exists what has been termed a "bewildering array of methods for determining how a market rate of interest is to be calculated."<sup>83</sup> A split remains in the various circuit courts' interpretations of the proper method to be used in determining the appropriate market rate for interest on restructured loans.<sup>84</sup>

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79. 11 U.S.C. § 1225(a) (1988).

80. *See supra* note 68 and accompanying text.

81. 5 COLLIER ON BANKRUPTCY ¶ 1225.03[4][c], at 1225-21 (15th ed. 1989).

82. R. RODGERS, COLLIER FARM BANKRUPTCY GUIDE ¶ 4.08[2] at 4-98 (L. King ed. 1990). With regard to FmHA loans, several courts have authorized a below-market interest rate. *In re Doud*, 74 Bankr. 865 (Bankr. S.D. Iowa 1987), *aff'd*, unrep. D.Ct. dec., *aff'd*, 869 F.2d 1144 (8th Cir. 1989); *In re Schaal*, 93 Bankr. 644 (Bankr. W.D. Ark. 1988); *In re Kesterson*, 94 Bankr. 561 (Bankr. W.D. Ark. 1987). This is justified by the fact that because of FmHA's special government subsidized role in agricultural lending, the contract rate for FmHA loans is below the market rate. *See ROTH, supra* note 68. *But see United States v. Arnold*, 878 F.2d 925 (6th Cir. 1989). *See also Case*, 115 Bankr. 671 (holding that FmHA is entitled to the "fair market rate" of interest, without addressing the special loan rates offered by FmHA; *infra* note 99).

83. RODGERS, *supra* note 82, at 4-98.

84. Commentators have also split in their opinions on this issue. For an interesting and lively interchange see Harl, *Determining "Present Value" in Bankruptcy*, 10 J. AGRIC. TAX'N & L. 170 (1988) [hereinafter Harl] (supporting a rate based on the Treasury bond

Two recent circuit decisions take very different views on this subject. The Ninth Circuit, in *In re Fowler*, authorized the use of a formula based on the prime rate plus an additional percent based on an individual risk factor.<sup>85</sup> This method, utilized in numerous other cases, is based on the concept of either the prime rate or the treasury bond rate as providing a floor, termed the "riskless" rate of interest.<sup>86</sup> From zero to three percent of the interest is then added on to this rate to compensate the lender for the risk of repayment that may accompany the loan. The percentage added on is determined according to a variety of factors, including the value and type of collateral, the risks inherent in the agricultural economy, and any risks associated with the specific situation of the debtor.<sup>87</sup>

In *Fowler*, the bankruptcy court applied the formula approach to loans owed to the Farm Credit Bank and the Interstate Production Credit Association. It computed the base rate according to the prime rate at the time of plan confirmation, and then added a risk factor of 0.75%. This produced a total rate of 9.5%.<sup>88</sup>

On appeal, the district court reversed and set the rate at 10.5%.<sup>89</sup> On further appeal, the Ninth Circuit reversed the district court and authorized the bankruptcy court's use of the formula approach. The case was remanded, however, for findings of fact to support the court's risk factor determination. The Ninth Circuit noted that the bankruptcy court should consider "evidence in the record . . . including information on market rates" as well as all "facts in the record which reduce *and* heighten the risks associated with the debtor."<sup>90</sup>

In contrast, the Tenth Circuit, in *In re Hardzog*, rejected this approach.<sup>91</sup> In *Hardzog*, the bankruptcy court had approved a reorganization plan that provided a secured claim holder with a ten percent

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rate plus a flat percentage increase), the article criticizing Professor's Harl's analysis, Duft & Frasier, *Computing the Correct Discount Rate for Deferred Payments Under Chapter 12 of the Bankruptcy Code*, 11 J. AGRIC. TAX'N & L. 253 (1990) (supporting a rate based on comparable loans), and Professor Harl's rebuttal, Harl, *Professor Harl's Response*, 11 J. AGRIC. TAX'N & L. 266 (1990).

85. 903 F.2d 694, 698 (9th Cir. 1990).

86. See, e.g., Doud, 869 F.2d 1145-46; *In re Wichmann*, 77 Bankr. 718 (Bankr. D. Neb. 1987). For a detailed discussion of this method of computing interest, see Harl, *supra* note 84, at 175-79. See also RODGERS *supra* note 82, at 4-100 (discussing the analysis of the bankruptcy court in *Wichmann*).

87. *In re Underwood*, 84 Bankr. 594 (Bankr. D. Neb. 1988). For a suggested listing of factors to be considered, see Harl, *supra* note 84, at 177-78.

88. *In re Fowler*, 83 Bankr. 39, 44 (Bankr. D. Mont. 1987).

89. *Fowler*, 903 F.2d at 695 (referencing unreported district court opinion).

90. *Id.* at 699.

91. *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990).

interest rate on a debt secured by a real estate mortgage. This rate was determined by the use of a base rate of 9.3% and adding a risk factor rate of 0.7%.<sup>92</sup> The district court affirmed the bankruptcy court's decision.<sup>93</sup>

On appeal, the Tenth Circuit held that absent special circumstances, the interest rate should be the "current market rate of interest used for similar loans in the region."<sup>94</sup> It specifically rejected the formula approach as not accurately reflecting the market rate.<sup>95</sup> In support of its position, the court expressed its concern that judges are not well suited to determine interest rates, and that in contrast, lenders are familiar with the assessment of risk factors in the setting of interest rates. As such, it stated that more fair results will be achieved by reference to the current rates being charged in the region.<sup>96</sup> On this basis, it reversed the district court's affirmance and remanded the case to the bankruptcy court.<sup>97</sup>

Subsequent to the *Fowler* and *Hardzog* circuit decisions, the Ninth Circuit Bankruptcy Appellate Panel decided *In re Case*.<sup>98</sup> Addressing the interest rate that FmHA must be paid, the court held that although a case-by-case approach was required, the proper rate was the "fair market value."<sup>99</sup> On this basis, it rejected the bankruptcy court's approval of a below-market rate for the FmHA loan at issue. However, the holding in *Case* is confusing because the court cites to *In re Doud* for authority; yet, *Doud* can be read as calling for a different result.<sup>100</sup>

The Eighth Circuit in *Doud* allowed a below-market rate for three of the debtors' FmHA loans, referencing the bankruptcy court's finding that these loans should be "viewed in light of the agency mission to provide credit to family farmers who are unable to obtain credit from conventional sources" and that such FmHA loan programs are a form of "social welfare."<sup>101</sup> The remaining FmHA loan was an emergency

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92. *In re Hardzog*, 77 Bankr. 840, 843 (Bankr. W.D. Okla. 1987).

93. *In re Hardzog*, 113 Bankr. 718, 722 (W.D. Okla. 1989).

94. *Hardzog*, 901 F.2d at 860. Although the court specifically reserved the right to define all of the "special circumstances" that would permit the court to deviate from this approach, it indicated that one such circumstance would be when the market rate was higher than the contract rate.

95. *Id.*

96. *Id.* See also Duft & Frasier, *supra* note 84 (advocating the use of this approach and criticizing the cost of funds formula approach as favoring debtors).

97. *Hardzog*, 901 F.2d at 860.

98. 115 Bankr. 666 (Bankr. 9th Cir. 1990) (The aspects of this case that involve the valuation of the creditor's secured claim are discussed *supra* notes 60-78 and accompanying text).

99. *Case*, 115 Bankr. at 670-71 (citing *Hardzog*, but apparently unaware of its own circuit's decision in *Fowler*).

100. *Id.* at 671 (citing *Doud*, 869 F.2d at 1145-46).

101. *In re Doud*, 74 Bankr. 865 (Bankr. S.D. Iowa 1987), *aff'd sub nom.* United

loan bearing a commercial rate of interest. For that loan, the court applied the formula approach approved in *Fowler*, adding a risk rate of two percent to the applicable treasury bond rate. *Case* followed neither approach, adding to the confusion surrounding this issue.

The controversy over the proper method of determining an appropriate interest rate for restructured loans is likely to continue to produce litigation. This result is unfortunate for both debtors and creditors because it increases the cost of bankruptcy proceedings by adding attorney hours and makes pre-bankruptcy evaluation and planning difficult. Over three years ago, the bankruptcy court in *Wichmann* rejected the current market rate in the region test, noting among other factors that it would require expert testimony in every case.<sup>102</sup> The court went on to indicate its preference for an easily ascertainable standard that would allow for sensible planning by both debtors and creditors and diminish litigation over interest rates.<sup>103</sup> Now, after years of litigation and commentary, not only is the standard in controversy, but the method of approaching it is as well.

#### *D. Livestock Operations: Lien Retention*

An area that has not previously produced reported appellate case law, but involves a fundamental issue for livestock operations, is the lien retention requirement of the section 1225 confirmation standards.<sup>104</sup> This issue was addressed recently in the Eighth Circuit case of *In re Hannah*.<sup>105</sup> Here, the court contrasted the "cramdown powers" of the Chapter 12 debtor<sup>106</sup> with the rights of a secured creditor having an interest in the debtor's livestock.

Again, the central issue in *Hannah* was section 1225(a)(5), which sets forth the requirements for plan confirmation. According to section 1225, a Chapter 12 plan that provides for the debtor's retaining possession of secured property cannot be confirmed without secured creditor approval unless the plan provides that the holder of a secured claim "retain the lien securing such claim."<sup>107</sup> The court interpreted this requirement

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States v. Doud, 869 F.2d 1144 (8th Cir. 1989). *See supra* notes 61, 82 and accompanying text.

102. *In re Wichmann*, 77 Bankr. 718, 720 (Bankr. D. Neb. 1987).

103. *Id.*

104. Bankruptcy court decisions that have addressed this issue include: *In re Underwood*, 87 Bankr. 594 (Bankr. D. Neb. 1988); *In re Milleson*, 83 Bankr. 696 (Bankr. D. Neb. 1988); *In re Big Hook Land & Cattle Co.*, 77 Bankr. 793 (Bankr. D. Mont. 1987); *In re Wobig*, 73 Bankr. 292 (Bankr. D. Neb. 1987).

105. 912 F.2d 945 (8th Cir. 1990)

106. *See supra* note 32 and accompanying text.

107. 11 U.S.C. § 1225(a)(5)(B)(i) (1988).

with regard to a creditor's interest in the debtor's herd of livestock.

The objecting creditor in *Hannah* called for a literal reading of the requirements of section 1225. Thus, it argued not only that its security interest in the debtor's livestock must be retained, but that this security interest applied specifically to each animal in the livestock herd as of the time of filing.<sup>108</sup>

In contrast, the debtor proposed a plan that allowed the sale of a portion of the livestock, free of the creditor's interest, for use in funding the plan and paying operating expenses. The plan provided for the granting of a second mortgage to the creditor in substitution for the security interest in the livestock to be sold, and provided for the creditor's retention of its interest in the remaining livestock.<sup>109</sup>

At confirmation, the value of the creditor's lien was approximately 120% of its claim. Under the proposed plan, its combined liens were estimated to be valued at 165% of its claim. Finding that the bank was adequately protected by the plan, the bankruptcy court confirmed the plan. On appeal, the district court affirmed.<sup>110</sup>

The Eighth Circuit reversed the lower courts, holding that the debtor's plan did not meet the requirements of section 1225. It found that the replacement lien offered to the creditor was inconsistent with the requirement that the creditor "retain the lien" securing its claim. The substitution of other collateral was unacceptable because it did not meet the specific requirement that the creditor retain "the lien."<sup>111</sup>

The court, however, also rejected the creditor's strict interpretation of section 1225. A literal interpretation of the lien retention requirements of section 1225 would require the debtor to turn over all proceeds of annual sales to the secured creditor, making no funds available to fund the plan or pay operating expenses. The court observed that under this interpretation, a livestock operation never could obtain confirmation of its plan absent creditor acceptance. Noting that it did not believe that Congress could have intended such a result, the court softened the meaning of "retain the lien." It held that this requirement can provide for the retention of a lien on the herd, as opposed to a lien on the particular animals in existence as of filing. The court stated that "this interpretation affords family farmers in the livestock business the potential to reorganize under Chapter 12, but does not depart completely from the express terms of section 1225(a)(5)(B)(i)."<sup>112</sup>

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108. *Hannah*, 912 F.2d at 948.

109. *Id.* at 947.

110. *Id.*

111. *Id.* at 951-52.

112. *Id.* at 950. This result was suggested by RODGERS, *supra* note 82, at ¶ 4.08[2] 4-95 to -97.

The court acknowledged, however, that this interpretation also presented a problem. Clearly, section 1225 does not authorize the termination of the creditor's lien on individual livestock sold under the plan in order to pay other creditors. To resolve this problem, *Hannah* asserted that section 552(b) may also be applicable to the livestock lien.<sup>113</sup>

Under section 552(b), the bankruptcy court may cut off a creditor's lien in certain proceeds, product, or offspring of pre-petition collateral after notice and hearing "on the equities of the case."<sup>114</sup> The court in *Hannah* noted that this 552(b) hearing can be incorporated into the plan confirmation hearing. A ruling on section 552(b), however, should "focus on the collateral that must be sold to implement the plan and whether cutting off the lien on that collateral would leave the creditor's claim without adequate protection under the plan."<sup>115</sup> Similarly, *Hannah* stated that the lien on the herd must adequately protect the creditor's secured claim over the course of the plan.<sup>116</sup>

Applying this standard to the facts in *Hannah*, the court reversed the lower courts' acceptance of the debtor's plan. It held that the bank's equity cushion in the livestock herd could not be replaced with a second real estate mortgage. This replacement did not meet the "retain the lien" requirement of section 1225.<sup>117</sup> Moreover, the court found insufficient assurance in the plan that the value of the herd would be maintained. It stated that the plan must assure the protection of the creditor's claim over the life of the plan.<sup>118</sup> Thus, although the plan at issue in *Hannah* was rejected, the court did use this rejection to define the ways in which a livestock operation can be reorganized despite the restrictive provisions of section 1225.

### III. CONCLUSION

Reports indicate that the number of Chapter 12 filings have never reached the total volume of early predictions and that current filings are down.<sup>119</sup> Moreover, commentators report a much publicized improvement in the farm economy.<sup>120</sup> Some may question the continued

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113. *Hanna*, 912 F.2d at 950-51.

114. 11 U.S.C. § 552(b) (1988) discussed in *Hannah*, 912 F.2d at 950.

115. *Hannah*, 912 F.2d at 950.

116. *Id.* at 951.

117. *Id.* at 952.

118. *Id.*

119. UNITED STATES, GENERAL ACCOUNTING OFFICE, PUB. No. RCED-89-142BR, FARM FINANCE: PARTICIPANTS VIEWS ON ISSUES SURROUNDING CHAPTER 12 BANKRUPTCY (1989).

120. See, e.g., Agri-News, Nov. 22, 1990, at A2, col. 2. See also Hanson, *Beyond the Debt Crisis*, CHOICES, Fourth Quarter 1990, at 33 (addressing the farm economy problems of the 1980s and providing strategies for maintaining the present improved debt to asset ratios in the 1990s).

utility of focusing on Chapter 12 developments. Several responses to this suggestion are appropriate.

First, although Chapter 12 filings may be less numerous at present, it remains an important frame of reference for rural financial workouts. Chapter 12 provides a baseline, and many farm loans have been and continue to be worked out voluntarily outside of bankruptcy because of the existence of Chapter 12.<sup>121</sup>

Second, although many farmers are experiencing better financial times than a few years ago, several factors point to increased volatility in the farm economy. These factors include low farm prices,<sup>122</sup> reduced subsidy payments and an increased tax burden as a result of deficit reduction measures,<sup>123</sup> dramatic farm policy changes advocated by the administration in its GATT proposals,<sup>124</sup> and higher than anticipated fuel and fertilizer costs as a result of the higher price of oil.<sup>125</sup> Although any one of these factors conceivably could be enough to make one leery of promises of a strong and stable farm economy, this combination of factors is truly unsettling.

Third, in the last few years, many farmers have restructured their debts with Farm Credit System and Farmers Home Administration under the Agricultural Credit Act of 1987.<sup>126</sup> For these farmers, the protections

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121. Bromley, *The Effects of the Chapter 12 Legislation on Informal Resolution of Farm Debt Problems*, 37 DRAKE L. REV. 197 (1987-1988).

122. Commentators predict continued low commodity prices as a result of 1990 surpluses. St. Paul Pioneer Press, Oct. 14, 1990, at 1H, col. 1.

123. A detailed analysis of the impact of the Farm Bill resulted in the conclusion that "the combined effects of the new taxes and budget cuts in farm programs will take a disproportionate share of deficit reduction from agriculture" and that "within agriculture, a disproportionate share of deficit reduction falls upon the midsized operation." 136 CONG. REC. S16,665 (daily ed. Oct. 25, 1990) (statement of Sen. Daschle incorporating National Farmers Union, *NFU Analysis Shows Farmers Singled Out in Budget Cuts* (1990)).

124. In this round of the GATT (General Agreement on Tariffs and Trade) negotiations, the United States has continuously advocated the elimination, over a ten-year period, of all market access restrictions and trade-distorting subsidies. While increased trade is the long-term goal of this proposal, in the short-term it is likely to mean cuts in farm income from further cuts in farm subsidy payments to U.S. farmers. UNITED STATES, GENERAL ACCOUNTING OFFICE, PUB. No. NSIAD-88-144BR, AGRICULTURAL TRADE NEGOTIATIONS 17-24 (1988).

125. It is estimated that farm fuel expenses may be 10% higher in 1990 than they were in 1989. Higher oil prices may also increase farm chemical costs 2-3%. Agweek, Nov. 26, 1990, at 32, col. 3.

126. For example, a study on the implementation of the Agricultural Credit Act of 1987 revealed that as of November 30, 1989, over one-third of the eligible delinquent FmHA borrowers qualified to have their debt restructured or to purchase their security property in a "net recovery buy-out." UNITED STATES, GENERAL ACCOUNTING OFFICE, PUB. No. T-RCED-90-38 (1990) (testimony of John W. Harman). While the total figures are not available to show how many of these borrowers actually restructured their loans,

of Chapter 12 were not needed. However, in the future, with FmHA attempting to move away from direct lending in favor of guaranteed loans,<sup>127</sup> and with the anticipated use of the new secondary loan market by FCS,<sup>128</sup> many of the borrower protections afforded by the Act will be unavailable.<sup>129</sup> Similarly, as farmland prices stabilize, statistics indicate a resurgence of private investment in agricultural loans.<sup>130</sup> The Agricultural Credit Act never has been applicable to private lenders. Borrowers from these sources will continue to rely on the provisions of Chapter 12 to provide the baseline for loan restructuring in times of stress.

Chapter 12 continues to be an important tool for farmers and as is presented in this Article, still produces interesting and highly contested litigation. It is this author's suggestion that it be preserved past its 1993 sunset.<sup>131</sup>

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presumably a significant number have obtained or will obtain restructuring relief outside of bankruptcy.

127. UNITED STATES, GENERAL ACCOUNTING OFFICE, PUB. NO. RCED-89-86, FARMERS HOME ADMINISTRATION: IMPLICATIONS OF THE SHIFT FROM DIRECT TO GUARANTEED FARM LOANS (1989); *see also* UNITED STATES, GENERAL ACCOUNTING OFFICE, PUB. NO. T-RCED-90-31, THE FARMERS HOME ADMINISTRATION'S GUARANTEED FARM LOAN PROGRAM 1-7 (statement of John W. Harman) (discussing problems associated with the increasing FmHA emphasis on the guaranteed loan program).

128. The Agricultural Credit Act authorized the creation of a secondary market for the pooling of agricultural loans. 12 U.S.C. §§ 2279aa to 2279aa-14 (1988).

129. Although the Agricultural Credit Act of 1987 authorizes FmHA to honor guaranteed loan commitments in certain voluntary debt reduction work outs, the primary lender is not subject to the debt restructuring requirements imposed on FmHA by the Act. 7 U.S.C. §§ 2005, 1999, 1983b, and 1989. *See Roth, supra* note 68, at 15.1-15.55. Similarly, with regard to Farm Credit System, borrowers that consent to the pooling of their loan onto the secondary loan market waive restructuring rights available to them as Farm Credit System borrowers under the Act. 12 U.S.C. § 2279aa-9(a),(b) (1988). *See also* Kelley & Hoekstra, *supra* note 56, at 227-28 (discussing FCS borrowers' rights and the secondary loan market).

130. Nationally, there has been a "steady erosion" of the loan market share held by FCS institutions over the last several years. Commercial banks have gained in the farm loan market and in 1989 held 32% of the U.S farm debt. 1989 FARM CREDIT ADMIN. ANN. REP. 31.

131. At the present time, Chapter 12 provisions are to be repealed by a sunset provision that takes effect on October 1, 1993. Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, tit. III, § 302(f), 100 Stat. 3124 (1986).

# Estate Planning for the Elderly and Disabled: Organizing the Estate to Qualify for Federal Medical Extended Care Assistance

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NEIL E. HARL\*\*

Perhaps the greatest fear of elderly Americans is the fear of becoming impoverished as a result of paying for their health care needs. This fear is not confined to a relatively small proportion of the population. Due to declining birth and mortality rates, the proportion of elderly in the population is expected to continue to grow.<sup>1</sup> In 1985, the eighty-five and over age group was twenty-two times larger than it was in 1900.<sup>2</sup> Thus, an increasing number of seniors are likely to experience frailty and disability in old age.

Even though the cost of nursing home care is high and individual patients are largely uninsurable,<sup>3</sup> for many elderly persons, old age means time spent in a nursing home.<sup>4</sup> Many feel that they are forced to enter

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1. Fertility in the United States has been below replacement level since 1972. See B. WATTENBERG, *THE BIRTH DEARTH* 7, 172 (1987). The proportion of elderly in the world population is also expected to continue to grow because the world-wide birth-rate is now falling faster than the mortality rate for the first time in recorded history. See Sherlock, *The Demographic Argument for Liberal Abortion Policies: Analysis of a Pseudo-Issue*, in *NEW PERSPECTIVES ON HUMAN ABORTION* 452 (T. Hilgers, D. Haran, & D. Hill ed. 1987).

2. AMERICAN ASSOCIATION OF RETIRED PERSONS, *A PROFILE OF OLDER AMERICANS* (Pamphlet No. D-996, 1986).

3. In 1986, the average annual nursing home cost was \$22,000. See J. CRICHTON, *THE AGE CARE SOURCEBOOK* 211 (1987). By 1988, the national average had risen to \$30,000. Norman, *Nursing-Home Insurance Out of Reach*, *Des Moines Register*, Jan. 23, 1990, at A1, col. 1. Approximately 80-85% of elderly Americans find private insurance for nursing home care prohibitively expensive. *Id.* However, this figure can be misleading. Long-term health care policies are not the answer for all elderly persons. For example, if an elderly person's parents or grandparents did not require long-term health care, the likelihood is greater that the elderly person will not require long-term health care. Similarly, the low income elderly are likely to be categorically eligible for Medicaid. See *infra* notes 15-16 and accompanying text.

4. According to the Department of Health and Human Services (HHS), 25% of Americans who live beyond the age of 65 will enter a nursing home. See Moorefield, *National Underwriter* 5 (Jan. 26, 1987). Currently, 25% of the population 85 and over live in nursing homes. See SUBCOMMITTEE ON HUMAN SERVICES OF THE HOUSE SELECT COMMITTEE ON AGING, 100TH CONG., 1ST SESS., *EXPLODING THE MYTHS: CAREGIVING IN AMERICA* 9 (Comm. Print 1987).

a nursing home once their personal and family finances have been depleted by providing in-home care to a spouse or they have outlived an income-producing or asset-owning spouse. Fewer than ten percent of nursing home residents have a child with an annual income over \$20,000, and seventy-five percent have no spouse to care for them at home.<sup>5</sup> Thus, typical nursing home residents are elderly persons who have outlived their spouses and their financial resources.

Except for the most wealthy elderly, the cost of long-term health care quickly becomes unmanageable. Consequently, the federal government is involved in assisting the elderly in meeting their long-term health care needs. To a limited extent, Medicare covers nursing home care. For example, if a covered individual is hospitalized for at least three days and is admitted to a nursing home within thirty days of discharge, Medicare covers the nursing home bill for the first twenty days of residency.<sup>6</sup> Between twenty and one hundred days, the resident pays the first \$74.00 each day and Medicare pays the balance.<sup>7</sup> Medicare does not cover any part of nursing home care for residencies extending beyond one hundred days.<sup>8</sup> The Medicaid program, on the other hand, is the primary source of public assistance for elderly persons living in nursing homes. Medicaid is a cooperative federal-state program designed to provide federal financial assistance to states choosing to reimburse certain costs of medical treatment for needy persons.<sup>9</sup>

The increased potential for an individual to experience costly long-term health care complicates estate planning. Estate maximization now includes structuring the estate so that eligibility for public benefit programs such as Medicaid may be established and maintained in light of the federal government's need to limit federal benefits to the truly needy. The purpose of this Article is to provide information about the Medicaid program's rules and regulations to those who counsel persons anticipating a need for Medicaid coverage so that maximum advantage can be taken of the Medicaid program's benefits and so that the possibility of adverse legal consequences can be reduced.

## I. MEDICAID ELIGIBILITY

In 1965, Congress established the Medicaid program as Title XIX of the Social Security Act to provide federal financial assistance to states

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5. K. DAVIS & D. ROWLAND, MEDICARE POLICY 62 (1986).

6. 42 U.S.C. § 1395d(a) (1988); 42 C.F.R. § 409.30 (1990).

7. 42 U.S.C. § 1395e(a)(3) (1988); 3 Medicare & Medicaid Guide (CCH) ¶ 13,010.80 (1990).

8. 42 U.S.C. § 1395d(a)(2)(A) (1988).

9. *Id.* §§ 1396, 1396a.

choosing to reimburse needy persons for certain medical treatment costs.<sup>10</sup> State participation in the Medicaid program is voluntary, but participating states must follow federal guidelines including requirements imposed by the Act and regulations promulgated by the Secretary of the Department of Health and Human Services (Secretary).<sup>11</sup> In order to assure the public that Medicaid funds are used to provide medical services to the needy and are not fraudulently diverted to untrustworthy providers of medical services, participating states must protect the quality and value of services rendered to recipients of Medicaid funds.<sup>12</sup> States that establish programs meeting the federal Medicaid guidelines and obtain the Secretary's approval are entitled to federal matching funds. However, once the Secretary determines that a state Medicaid plan has failed to comply with federal guidelines, the Secretary is required to take action.<sup>13</sup>

To qualify for Medicaid assistance in a participating state, an applicant must meet three general tests: (1) the Medicaid applicant must be in a category of persons entitled to participate in the program;<sup>14</sup> (2) the applicant's assets must be within specified levels; and (3) the applicant's available income must be less than a prescribed amount to avoid having any of the applicant's income used to pay medical expenses. Thus, the three tests that each Medicaid applicant must meet to qualify for Medicaid assistance in any participating state are: circumstances, assets, and income.

#### *A. Circumstances Test*

The circumstances test entitles certain categories of persons to Medicaid benefits. As originally enacted, Medicaid required participating states to provide medical assistance to individuals who were receiving cash

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10. Title XIX of the Social Security Act, Pub. L. No. 89-97, § 121(a), 79 Stat. 343 (1965) (codified as amended at 42 U.S.C. §§ 1396-1396s (1988)).

11. *See* 42 U.S.C. § 1396 (1988); *Schweiker v. Gray Panthers*, 453 U.S. 34, 37 (1981); *Illinois Hosp. Assoc. v. Illinois Dep't of Pub. Aid*, 576 F. Supp. 360, 360 (N.D. Ill. 1983). Participating states must also provide financial assistance for inpatient, outpatient, laboratory, X-ray, skilled nursing facility, and physicians' services. *See Weaver v. Reagen*, 886 F.2d 194, 197 (8th Cir. 1989).

12. *Medicon Diagnostic Laboratories, Inc. v. Perales*, 74 N.Y.2d 539, 545, 549 N.E.2d 124, 127, 549 N.Y.S.2d 933, 936 (1989).

13. 42 U.S.C. § 1396c (1988). The Secretary may waive the requirements of § 1396a when approving a state Medicaid demonstration program. *See id.* § 1315; *Phoenix Baptist Hosp. & Medical Center v. United States*, 728 F. Supp. 1423, 1426 (D. Ariz. 1989).

14. These persons generally include recipients of Supplemental Security Income (SSI) or Aid to Families with Dependent Children. 42 U.S.C. § 1396a(a)(10) (1988); 42 C.F.R. §§ 435.120-.136 (1990).

payments under any one of four welfare programs established in the Social Security Act.<sup>15</sup> These persons were termed the "categorically needy," and all participating states were required to provide benefits to these persons.<sup>16</sup>

In addition, a state could provide benefits to the "medically needy." The medically needy are persons whose incomes are too high to qualify for one of the categorical programs, yet they meet all other categorical criteria.<sup>17</sup> Medically needy persons are eligible for Medicaid when their combined assets and income are insufficient to meet the cost of necessary medical or remedial services.<sup>18</sup> If a state chooses to provide benefits to both the categorically needy and the medically needy, the regulatory procedure employed in determining income and resource eligibility for medically needy applicants may be less restrictive, but no more restrictive than the procedure used to determine income and resource eligibility for categorically needy applicants.<sup>19</sup> In general, categorical eligibility should not be a problem for most elderly persons living in states that cover the medically needy.

In 1972, Congress restructured the Social Security program and replaced three of the four welfare assistance programs with Supplemental Security Income (SSI) for the aged, blind, and disabled.<sup>20</sup> Under SSI, the federal government assumed responsibility for both the funding of payments and the setting of eligibility standards.<sup>21</sup> Congress also retained the requirement that all recipients of categorical welfare assistance, including the new SSI program, are entitled to Medicaid.<sup>22</sup> As a result of this statutory restructuring, however, the new SSI income eligibility limits became broader than some of the prior state-established criteria. Thus, the number of individuals eligible for Medicaid under the new SSI standards increased significantly in many states.<sup>23</sup>

In 1974, Congress offered participating states the "section 209(b) option" because Congress feared that some states might withdraw from

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15. See, e.g., *Herweg v. Ray*, 455 U.S. 265, 268 (1982). These programs included: Old Age Assistance, Aid to Families with Dependent Children, Aid to the Blind, and Aid to the Permanently and Totally Disabled. *Schweiker v. Gray Panthers*, 453 U.S. 34, 37 n.1 (1981).

16. 42 U.S.C. § 1396(e)(10) (1988). See also *Randall v. Lukhard*, 709 F.2d 257 (4th Cir. 1983), modified, 729 F.2d 966 (1984) (en banc).

17. 42 U.S.C. § 1396a(10)(C) (1988); 42 C.F.R. § 435.1(b)(3)(i) (1990).

18. See 42 C.F.R. §§ 438.800-.852.

19. 42 U.S.C. § 1396a(r)(2) (1988).

20. *Id.* §§ 1381-94. Aid to Families with Dependent Children (AFDC) was not federalized under SSI. See *id.* §§ 601-17.

21. See *id.* §§ 1381-94.

22. See *id.* § 1396(a)(10).

23. See, e.g., *Darling v. Bowen*, 878 F.2d 1069, 1071 (8th Cir. 1989), cert. denied *sub nom. Stangler v. Darling*, 110 S. Ct. 1782 (1990).

the Medicaid program rather than bear the extra costs associated with the restructuring.<sup>24</sup> Under section 209(b), participating states can opt out of the requirement of providing Medicaid assistance to persons who receive SSI, and may elect to provide Medicaid assistance only to those individuals who would have been eligible under the state's Medicaid plan in effect on January 1, 1972, provided that these eligibility criteria are more restrictive than the SSI criteria.<sup>25</sup> Therefore, SSI eligibility does not necessarily guarantee Medicaid eligibility in states electing the section 209(b) option. Thus, the section 209(b) option allows states to avoid the effect of the link between the SSI and Medicaid programs, and permits states to become either "section 209(b) states" or "SSI states."

If a state elects the section 209(b) option, its Medicaid eligibility requirements may be no more restrictive than the requirements in effect under the state's Medicaid plan on January 1, 1972.<sup>26</sup> Alternatively, each requirement may be no more liberal than that applied under SSI.<sup>27</sup> Thus, states may cover all SSI recipients or establish requirements that are more restrictive than SSI but that are no more restrictive than the requirements in effect under the particular state's plan on January 1, 1972. Coverage of the medically needy, however, is mandatory in section 209(b) states.<sup>28</sup>

Section 209(b) states may use more restrictive definitions of blindness or disability than SSI states.<sup>29</sup> Section 209(b) states may also adopt disability determinations of the Social Security Administration (SSA), and are not required under federal law to make an independent determination of a Medicaid applicant's disability.<sup>30</sup> For example, in *Armstrong v. Palmer*,<sup>31</sup> the plaintiff applied for SSI benefits, but failed to qualify due to an SSA finding that the plaintiff was not disabled. Although she did not have a change in physical condition, the plaintiff applied for Medicaid benefits under Iowa's Medicaid plan. The Iowa state agency denied the plaintiff's application based on the SSA's determination of nondisability. The Eighth Circuit Court of Appeals ruled for the Iowa agency, and stated that when the SSA has determined that an individual is not disabled, that determination settles the question of

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24. Section 209(b) of the Social Security Act is set forth at 42 U.S.C. § 1396a(f) (1988).

25. 42 U.S.C. § 1396a(f) (1988); 42 C.F.R. § 435.121(6)(1) (1990).

26. 42 C.F.R. § 435.121(b)(1) (1990).

27. *Id.*

28. See 42 U.S.C. § 1396(a)(10) (1988); *Winter v. Miller*, 676 F.2d 276, 278 (7th Cir. 1982).

29. 42 C.F.R. § 435.121(a) (1990).

30. This reflects the Secretary's interpretation of 42 C.F.R. §§ 435.210 and 435.541.

31. 879 F.2d 437 (8th Cir. 1989).

SSI eligibility and consequently, Medicaid eligibility.<sup>32</sup> The court emphasized that its ruling furthered Congress's desire to avoid spending limited public benefit funds to duplicate the eligibility determination work of the federal agency.<sup>33</sup>

### *B. Income Test*

1. *General Provisions.*—The income test serves the dual purpose of determining whether an applicant is eligible to receive Medicaid benefits and how much an applicant must contribute toward medical care from personal income. The income eligibility requirements for a particular Medicaid applicant depend upon two factors: (1) whether the applicant resides in an SSI state or a section 209(b) state and (2) whether the applicant is classified as categorically or medically needy.<sup>34</sup> A third factor to remember is that SSI states have the option of covering the medically needy, and those SSI states that do cover the medically needy may set higher income eligibility limits than those used in determining eligibility for other Social Security cash assistance programs.<sup>35</sup>

For the medically needy, the income test is based upon monthly income limits that vary from state to state. While excess income does not bar Medicaid participation, it does require that the applicant incur medical bills equal to the excess of available income over the applicable income limit.<sup>36</sup> For example, assume that X lives alone, requires twenty-four hour medical care, and resides in either a section 209(b) state or an SSI state that covers the medically needy. X's only income is from Social Security in the amount of \$900 per month. If we assume that the monthly income limit for a one person household is \$386 (the Iowa limit), X's excess income is \$514. X is eligible for Medicaid if X's monthly medical bills average \$515. Although it would not be likely in this example, X will not be eligible for Medicaid if X's monthly income exceeds the per month cost of nursing home care.

2. *Available Income.*—The standards used in determining Medicaid eligibility provide in part that a state's plan for medical assistance must take into account only the income and resources that are "available"

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32. *Id.* at 440.

33. *Id.*

34. The financial eligibility requirements for the categorically needy are set forth in 42 C.F.R. §§ 435.700-.740 (1990). The applicable financial eligibility requirements for categorically needy applicants residing in section 209(b) states are found in 42 C.F.R. §§ 435.731-.735. The financial requirements for medically needy applicants are specified in 42 C.F.R. §§ 435.800-.852.

35. 42 C.F.R. § 435.1(b)(3)(i) (1990).

36. Thus, medically needy persons become eligible for Medicaid when their medical bills make them categorically needy.

to the applicant.<sup>37</sup> The determination of available income has become an increasingly important Medicaid eligibility issue in recent years. An important point, however, is that from an estate planning standpoint, available income is a broadly defined concept. As a result, the determination of a particular applicant's available income may depend upon such factors as the income and resources of the applicant's spouse, the amount of monthly income received in the applicant's name, the applicant's countable income as opposed to actual income, and the amount of the applicant's income applied toward outstanding medical bills.<sup>38</sup>

3. *Deeming.*—The income and resources of a Medicaid applicant's spouse can be considered available to the Medicaid applicant through the process of "deeming." The Secretary has promulgated regulations governing the administration of Medicaid benefits in both SSI states and section 209(b) states that describe the circumstances under which the income of a Medicaid applicant's spouse may be deemed available to the applicant. For example, SSI states are required to "consider the income and resources of spouses living in the same household as available to each other, whether or not they are actually contributed."<sup>39</sup>

The amount of a Medicaid applicant's available income may also depend upon the order in which federal medical assistance benefits are calculated if an applicant is applying for benefits under separate federal programs. For example, in *Mazza v. Secretary of Department of Health and Human Services*,<sup>40</sup> the claimant filed concurrent claims for Social Security Disability and Supplemental Security Income payments. The SSA calculated the disability benefits first and offset them against potential SSI payments. As a result, the claimant was saddled with a large debt for medical expenses, and was denied SSI and Medicaid benefits due to excess available income.<sup>41</sup>

The court cited favorably a congressional committee report discussing the Disability Benefits Reform Act of 1984 that stated that the overall purpose of the Act was "to clarify statutory guidelines for the deter-

37. See 42 U.S.C. § 1396a(a)(17) (1988). Additionally, an applicant's failure to provide the information that a state agency deems necessary to determine the applicant's eligibility may justify denying a Medicaid application. Likewise, the state agency, not the applicant's counsel, must make Medicaid eligibility determinations. *Badenhausen v. New York State Dep't of Social Servs.*, 151 A.D.2d 913, 914, 542 N.Y.S.2d 887, 887 (1989).

38. Likewise, courts have held that "available income" includes mandatory tax withholdings. *Heckler v. Turner*, 470 U.S. 184, 211 (1985). Cf. *Whitehouse v. Ives*, 736 F. Supp. 368, 379 (D. Me. 1990) (retirement payments included as income for determining Medicaid eligibility). Similarly, the cash value, rather than the face value, of an insurance policy is included in "available income" for purposes of calculating SSI eligibility. See *Wilczynski v. Harder*, 323 F. Supp. 509, 517 (D. Conn. 1971).

39. 42 C.F.R. § 435.723(b) (1990).

40. 903 F.2d 953 (3d Cir. 1990).

41. *Id.* at 955.

mination process to insure that no beneficiary loses eligibility for benefits as a result of careless or arbitrary decisionmaking by the Federal government.”<sup>42</sup> The court also recognized a long-standing practice in the courts of calculating SSI benefits and subtracting them from Title II disability benefits.<sup>43</sup> As a result, the *Mazza* court held that the agency’s calculation, which offset disability benefits against potential SSI payments, was arbitrary and inconsistent with the overall objectives of the Social Security system.<sup>44</sup>

When the applicant and his or her spouse cease living together, the spouse’s income is disregarded unless actually contributed to the other spouse in or after the month of the separation unless both the spouse and the applicant apply or are otherwise eligible for Medicaid or SSI.<sup>45</sup> If both spouses apply or are eligible for Medicaid or SSI, the income of both the spouse and the applicant is considered available to each for six months following the month in which they were separated.<sup>46</sup>

Section 209(b) states have greater authority to deem income available to a spouse. Section 209(b) states are required to deem income available to the extent required in SSI states, and have the option of deeming to the full extent of the requirements in effect under the state’s Medicaid plan on January 1; 1972.<sup>47</sup> Additionally, income deemed available to a spouse may be considered unavailable to an applicant in a section 209(b) state when the spouse and the applicant reside in the same house and the Secretary determines that deeming would be inequitable.<sup>48</sup> Thus, the overall effect of deeming, in both SSI and section 209(b) states, is to reduce the number of Medicaid eligible persons and the amount of assistance paid to qualified applicants.

In *Schweiker v. Gray Panthers*,<sup>49</sup> the respondent argued that “‘deeming’ impermissibly uses an ‘arbitrary formula’ to impute a spouse’s income to an institutionalized Medicaid applicant.”<sup>50</sup> The respondent argued that the state must make a factual determination that the spouse’s income is actually contributed to the applicant before calculating the applicant’s benefits. The respondent also maintained that “‘deeming’ was inconsistent with a regulation providing that only income “available”

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42. *Id.* at 960 (citing H.R. REP. No. 618, 98th Cong., 2d Sess. 2, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 3038, 3039).

43. *Id.* at 956.

44. *Id.* at 960.

45. 42 C.F.R. § 435.723(d) (1990).

46. *Id.* § 435.723(c)(1)(ii).

47. *Id.* § 435.734(a); *Schweiker v. Gray Panthers*, 453 U.S. 34, 40 (1981).

48. 42 C.F.R. § 435.734(b)(1), (2) (1990).

49. 453 U.S. 34 (1981).

50. *Id.* at 40.

to the applicant may be considered in establishing Medicaid eligibility. Specifically, the statute in question provided that in calculating benefits, state Medicaid plans must "not take into account the financial responsibility of any individual for any applicant or recipient of assistance under the plan *unless such applicant or recipient is such individual's spouse* or such individual's child who is under age 21 or [in certain circumstances], is blind or permanently and totally disabled . . . ."<sup>51</sup>

The Court, noting that Congress gave the Secretary exceptionally broad authority to promulgate regulations for defining Medicaid eligibility, ruled that the Secretary's definition of "available income" was entitled to "legislative effect," and held that the deeming regulation at issue was consistent with the Medicaid statute.<sup>52</sup> The Court also examined Medicaid's legislative history and determined that from its inception Congress has endorsed the concept of spousal deeming.<sup>53</sup> The Court also held that the administration of public assistance payments based on a formula was not inherently arbitrary because a requirement of individual need determinations would mandate costly fact-finding procedures that would deplete resources that could have been spent on the needy.<sup>54</sup>

As mentioned above, deeming practices differ between SSI states and section 209(b) states.<sup>55</sup> In particular, deeming in section 209(b) states proceeds in a more direct manner. Typically, a section 209(b) state specifies a "maintenance" level of income and resources for the non-institutionalized spouse.<sup>56</sup> Any funds exceeding the prescribed amount are deemed available for the costs of institutionalization, and medical assistance is usually terminated if the noninstitutionalized spouse fails to contribute the excess amount.<sup>57</sup>

Section 209(b) states must follow the federal regulations governing the treatment of income of institutionalized Medicaid recipients in these states. One regulation provides in part that "[t]he agency must reduce its payment to an institution, for services provided to an individual . . . by an amount that remains after deducting the amounts specified in paragraphs (c) and (d) . . . from the individual's total income . . . ."<sup>58</sup> Similarly, state health care agencies in section 209(b) states must deduct

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51. *Id.* at 44 (citing 42 U.S.C. § 1396a(a)(17)(D)) (emphasis in original).

52. *Id.* at 48.

53. *Id.* at 44.

54. *Id.* at 48.

55. See *supra* notes 47-48 and accompanying text.

56. See, e.g., *Gray Panthers v. Administrator, Health Care Fin. Admin.*, 629 F.2d 180, 182 (D.C. Cir. 1980), *rev'd*, *Schweiker v. Gray Panthers*, 453 U.S. 34 (1981).

57. *Id.*

58. 42 C.F.R. § 435.733(a) (1990).

certain amounts from a Medicaid recipient's total income, including sums that were disregarded in determining Medicaid eligibility. The pertinent federal regulation provides:

The agency must deduct the following amounts, in the following order, from the individual's total income . . .

(1) a personal needs allowance that is reasonable in amount for clothing and other personal needs of the individual while in the institution . . .

(2) For an individual with only a spouse at home, an additional amount for the maintenance needs of the spouse. This amount must be based on a reasonable assessment of need but not exceed the higher of —

(i) The more restrictive income standard established under § 435.121; or

(ii) The medically needy standard for an individual.<sup>59</sup>

Because section 209(b) states do not have a medically needy program, the spousal maintenance deduction may be no more restrictive than the requirements in effect under the particular state's Medicaid plan on January 1, 1972, and no more liberal than that applied under SSI.<sup>60</sup>

In *Mattingly v. Heckler*,<sup>61</sup> the spouse of an institutionalized Medicaid recipient brought suit challenging the procedures used for deeming spousal income in Indiana, which is a section 209(b) state. The Indiana regulations governing the income eligibility of institutionalized Medicaid recipients require the Indiana state Medicaid agency to deduct a prescribed sum from the recipient's monthly income for the recipient's personal needs and an additional sum as a monthly maintenance allowance for the recipient's noninstitutionalized spouse.<sup>62</sup> Income remaining after these deductions is considered available to defray the Medicaid recipient's medical care costs.<sup>63</sup>

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59. *Id.* § 435.733(c)(1), (2)(ii).

60. See *id.* § 435.121(b)(1). In *Walsh v. Walsh*, 144 A.D.2d 947, 534 N.Y.S.2d 260 (1988), the Supreme Court Appellate Division reversed a lower court's holding that an institutionalized person without sufficient income to meet daily medical expenses is not responsible for contributing to the support of a noninstitutionalized spouse, and held that the income of a nursing home resident is available to support a noninstitutionalized spouse even though the person is a Medicaid recipient.

61. 784 F.2d 258 (7th Cir. 1986).

62. IND. CODE ANN. § 12-1-7-18.6 (West 1982 & Supp. 1990). At the time the case was decided, the monthly maintenance allowance was calculated by subtracting the noninstitutionalized spouse's income from \$325. Noninstitutionalized spouses with monthly incomes exceeding \$325 received no monthly maintenance allowance, and the excess was deemed available to the Medicaid applicant for application to the cost of medical care. *Heckler*, 784 F.2d at 263.

63. *Heckler*, 784 F.2d at 263.

The plaintiffs objected to the agency's mechanical subtraction of the monthly spousal maintenance allowance. Specifically, the plaintiffs claimed that the Indiana regulations were unconstitutional under the due process clauses of the fifth and fourteenth amendments because they failed to provide spouses of institutionalized Medicaid recipients an opportunity to demonstrate that the spouse's actual needs exceeded the prescribed monthly allowance. Thus, the plaintiffs argued that the Medicaid statute prohibited the use of a flat maintenance allowance that did not reflect the needs of a particular spouse.

The Seventh Circuit Court of Appeals rejected the plaintiffs' claims on three grounds. First, the court ruled that the applicable federal regulation<sup>64</sup> prevented the Medicaid program from granting more financial assistance to the noninstitutionalized spouse of a Medicaid recipient than the Medicaid program granted its own beneficiaries, and that it treated all recipients equally.<sup>65</sup> Second, the court held that the Indiana monthly maintenance allowance was within the federally prescribed range and was tied to the state SSI benefit rates (that is, the maximum monthly income that a single person may receive and still qualify for Medicaid benefits in Indiana).<sup>66</sup> Third, the court echoed the concern in *Schweiker* that requiring individual fact-finding procedures would dissipate funds that could have been spent on the needy.<sup>67</sup> Thus, the court held that the use of a flat rate maintenance allowance to provide for the needs of an institutionalized Medicaid recipient's spouse is not unconstitutional.<sup>68</sup>

In recent years, Congress's attempts to reduce the federal budget deficit have led to a tightening of the eligibility standards for public welfare benefits. A primary concern is the impact that such attempts might have on the status of categorically needy persons who qualify for Medicaid benefits under a Medicaid related SSI program. For example, the Deficit Reduction Act of 1984 (DEFRA) amended the Aid to Families with Dependent Children (AFDC) financial eligibility requirements by deeming the income of siblings in the form of Social Security or child support benefits and the income of grandparents to be available to the AFDC filing unit.<sup>69</sup> As a result, DEFRA disqualified some AFDC family filing units from receiving further AFDC benefits.<sup>70</sup> Because AFDC and SSI benefit recipients are categorically eligible for Medicaid, the question

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64. 42 C.F.R. § 435.733 (1990).

65. *Heckler*, 784 F.2d at 266 (construing 42 C.F.R. § 435.733).

66. *Id.* at 267.

67. *Id.* at 268.

68. *Id.* at 270.

69. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 2640(38)(B), 98 Stat. 1145 (codified as amended at 42 U.S.C. § 602(a)(38) (1988)).

70. See, e.g., *Rosado v. Bowen*, 698 F. Supp. 1191 (D.N.J. 1982).

becomes whether individuals denied further AFDC or SSI benefits by DEFRA are also automatically disqualified from Medicaid benefits.

Numerous courts have decided the AFDC issue, and have held that DEFRA's "increased deeming" provisions do not operate to disqualify the categorically needy from further Medicaid benefits.<sup>71</sup> Arguably, the same logic should be applied to reach a similar result in situations where an individual qualifies for Medicaid benefits under the SSI program.<sup>72</sup>

A recent California case emphasizes the point that state Medicaid plans are prohibited from imposing financial responsibility for medical care on persons other than spouses and parents. In *Sneede ex rel. Thompson v. Kizer*,<sup>73</sup> the court invalidated California's Medicaid regulations that deemed income and resources of all persons in the family unit available to a family member seeking Medicaid benefits.<sup>74</sup> In invalidating the California plan, the court stated that the plain meaning of the Medicaid statute explicitly prohibited the deeming of income from persons other than a Medicaid applicant's spouse or from a parent in the case of a child who is under age twenty-one, blind, or permanently

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71. A number of courts have held that the DEFRA regulations do not affect a Medicaid applicant's status. *See, e.g.*, *Malloy v. Eichler*, 860 F.2d 1179, 1185 (3d Cir. 1988) (Medicaid eligibility not derivative of or perfectly coextensive with AFDC eligibility); *Mitchell v. Lipscomb*, 851 F.2d 734, 736 (4th Cir. 1988) (Congress knew of limitations that Medicaid statute imposed on Secretary's authority when DEFRA was passed, and chose not to change Medicaid eligibility requirements); *Georgia Dep't of Medical Assistance v. Bowen*, 846 F.2d 708, 712 (11th Cir. 1988) (AFDC and Medicaid benefits are fundamentally different — AFDC benefits are shared by family members, whereas Medicaid benefits are for individual health care, and DEFRA contained no amendments specifically directed at § 1396a(a)(17)(D) of Medicaid statute); *Childress v. Bowen*, 833 F.2d 231, 233 (10th Cir. 1987) (Medicaid statute precludes Secretary from applying § 602(a)(38) of DEFRA to include sibling income in calculating family income for determining Medicaid benefits); *Olson v. Norman*, 830 F.2d 811, 818 (8th Cir. 1987) (DEFRA does not affect Medicaid eligibility); *Rosado v. Bowen*, 698 F. Supp. 1191, 1197 (D.N.J. 1987), *aff'd*, 860 F.2d 1179 (3rd Cir. 1988) (42 U.S.C. § 1396a(a)(17)(D) specifically prohibits deeming of sibling income as DEFRA requires); *Gibson v. Puett*, 630 F. Supp. 542, 544 (M.D. Tenn. 1985) (Medicaid must be provided to persons ineligible for AFDC solely because of sibling or nonparental caretaker income).

72. In *Massachusetts Association of Older Americans v. Sharp*, 700 F.2d 749 (1st Cir. 1983), the court held that states may not deny Medicaid benefits to persons who would be eligible for cash assistance but for their failure to satisfy requirements that are specifically prohibited under the Medicaid program. Additionally, upon receiving notice that an individual's SSI benefits have been terminated, the state agency must promptly determine *ex parte* the individual's eligibility for Medicaid independent of the individual's SSI eligibility, and pending the outcome of the determination, continue to furnish Medicaid benefits to the individual. *See also Crippen v. Kheder*, 741 F.2d 102, 107 (6th Cir. 1984) (Department of Social Services must determine Medicaid eligibility separate from SSI eligibility and must provide Medicaid benefits while the eligibility determination is made).

73. 728 F. Supp. 607 (N.D. Cal. 1990).

74. *Id.* at 612.

and totally disabled.<sup>75</sup> Thus, under current law, the Medicaid statute prevents the deeming of income and resources of any individual absent actual contribution, except from a spouse to a spouse or from a parent to a child.

4. *The "Name-on-the-Check" Rule.*—Another issue concerning available income, and closely related to the issue of deeming, involves the "name-on-the-check" rule. This rule "requires that a Medicaid applicant's eligibility for benefits be based on the amount of money that the applicant receives each month in his or her name."<sup>76</sup> The rule represents the Secretary's administrative interpretation of the word "income" in the pertinent Medicaid regulation,<sup>77</sup> and has no explicit basis in either the Medicaid statute or the Medicaid regulations.<sup>78</sup>

Although the term "income" as used in federal statute and regulations is to be defined under state law,<sup>79</sup> the "name-on-the-check" rule does not consider the portion of a married applicant's monthly income that belongs to the applicant's spouse under state community property law.<sup>80</sup> As a result, applying the "name-on-the-check" rule in community

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75. *Id.* at 610. See 42 U.S.C. § 1396a(a)(17)(D) (1988) (consideration of financial responsibility prohibited unless person is applicant's spouse, child under age 21, or is blind or disabled).

76. See, e.g., *Washington Dep't of Social & Health Servs. v. Bowen*, 815 F.2d 549, 552 (9th Cir. 1987).

77. (b) The agency must consider income and resources of spouses living in the same household as available to each other, whether or not they are actually contributed.

(c) If both spouses apply or are eligible as aged, blind, or disabled and cease to live together, the agency must consider their income and resources as available to each other for the time periods specified below. After the appropriate time period, the agency must consider only the income and resources that are actually contributed by one spouse to the other.

(1) If spouses cease to live together because of the institutionalization of one spouse —

(i) The agency must consider their income as available to each other through the month in which they cease to live together. Mutual consideration of income ceases with the month after the month in which separation occurs. . . .

(d) If only one spouse in a couple applies or is eligible, or both spouses apply and are not eligible as a couple, and they cease to live together, the agency must consider only the income and resources of the ineligible spouse that are actually contributed to the eligible spouse beginning with the month after the month in which they cease to live together.

42 C.F.R. § 435.723 (1990).

78. *Bowen*, 815 F.2d at 553.

79. See *Poe v. Seaborn*, 282 U.S. 101, 110 (1930) (the term "income of" in a federal tax statute indicates ownership as defined under state law).

80. In community property states, all marital property is owned in common by husband and wife, with each spouse having an undivided one-half interest by reason of their marital status. Thus, in community property states, one half of the earnings of each

property states may adversely affect the at-home spouse of an institutionalized Medicaid recipient if the spouse earning the income becomes institutionalized.<sup>81</sup>

For example, assume that an elderly couple resides in a community property state. Assume also that the couple receives \$1,000 per month in the husband's name and nothing in the wife's name. If the wife enters a nursing home, the "name-on-the-check" rule requires that her Medicaid eligibility be based exclusively on the income received in her name (zero), and allows the husband use of the full \$1,000 received in his name, subject to spousal deeming. Alternatively, if state community property law is applied, the wife's Medicaid income eligibility will be based on her one-half interest in her husband's income (\$500), and the husband will have use of the remaining \$500.

If, however, the husband becomes institutionalized, under the "name-on-the-check" rule, his Medicaid income eligibility will be based on the \$1,000 received in his name and his wife will be left to live at home entirely dependent on a spousal maintenance allowance. Under state community property law, the husband's eligibility will be based on \$500, leaving \$500 for the wife's use. Thus, the impact of the "name-on-the-check" rule is especially harsh on lower income at-home spouses of nursing home patients when it is applied in community property states. Conversely, the "name-on-the-check" rule favors those couples when the lower income-earning spouse must be institutionalized.

In *Washington Department of Social and Health Services v. Bowen*,<sup>82</sup> the state of Washington submitted a Medicaid plan amendment for the Secretary's approval. Under the amendment, the eligibility of married applicants for benefits would be calculated under state community prop-

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spouse are considered owned by the other spouse. Alternatively, under a common-law system, each spouse owns whatever he or she earns. Currently, there are nine states with community property systems. *See* ARIZ. REV. STAT. ANN. § 25-211 (1976 & Supp. 1990); CAL. CIV. CODE § 682 (West 1982 & Supp. 1990); IDAHO CODE § 32-906 (1983 & Supp. 1990); LA. REV. STAT. ANN. §§ 2325, 2327, 2338 (West 1979 & Supp. 1991); NEV. REV. STAT. ANN. §§ 123.225, 123.259 (Michie 1982); N.M. STAT. ANN. § 40-3-12 (1989); TEX. FAM. CODE ANN. §§ 5.01, 5.02 (1984 & Supp. 1990); WASH. REV. CODE ANN. § 26.16.030 (1986 & Supp. 1991); WIS. STAT. ANN. §§ 766.01-82 (West 1987 & Supp. 1990). The remainder of the states are classified as common-law jurisdictions.

81. The effect on the at-home spouse may be particularly severe on elderly couples. Most elderly couples receive the majority of their income in the husband's name. *See* U.S. BUREAU OF THE CENSUS, CURRENT POPULATION REPORT (1985) (Ser. P-60, No. 146, Table 37). Furthermore, given any married couple, the husband is more likely to enter a nursing home than is the wife. *See generally* Mitchell, *Spousal Impoverishment: Medicaid Burdens on the At-Home Spouse of a Nursing Home Resident*, 20 CLEARINGHOUSE REV. 358 (1986).

82. 815 F.2d 549 (9th Cir. 1987).

erty law, rather than under the "name-on-the-check" rule.<sup>83</sup> The Ninth Circuit Court of Appeals reversed the Secretary's disapproval of the amendment on the ground that the states are free to devise their own reasonable standards for determining Medicaid eligibility.<sup>84</sup> Specifically, the court ruled that the term "available" in the Medicaid regulations must be read as a limiting term, and that "income" should be defined under state law in community property states.<sup>85</sup> The court noted that under the "name-on-the-check" rule, deeming would occur indefinitely, thereby violating the purpose of the Medicaid regulations.<sup>86</sup> Furthermore, the court stated that the DEFRA regulations barred the Secretary from disapproving less restrictive state plans during a moratorium period which was in effect when the Secretary disapproved Washington's plan amendment.<sup>87</sup> The court found Washington's plan amendment to be less restrictive than the Secretary's interpretation; therefore, it was protected from the Secretary's disapproval.<sup>88</sup>

In a Minnesota case, *Rindahl v. St. Louis County Welfare Board*,<sup>89</sup> the court held that the "name-on-the-check" rule was not an overbroad interpretation of the Medicaid regulations requiring that state eligibility determinations take into account only income that is "available" to the applicant.<sup>90</sup> The plaintiff in *Rindahl* was afflicted with Parkinson's disease and entered a nursing home after ten years of in-home care. The plaintiff had a monthly income over \$1,500, but his wife had no independent source of income. The defendant used the "name-on-the-check" rule to determine Medicaid eligibility and attributed all of the couple's income to the plaintiff. The plaintiff brought suit claiming that his wife's monthly maintenance allowance was inadequate, and that even though Minnesota was a common-law property state, Minnesota's marital property division statutes should entitle her to one half of his income as a maintenance allowance.

In holding that the "name-on-the-check" rule was a plausible method for attributing income, the court noted that indefinite deeming would not occur because the plaintiff's wife was not a wage earner to which

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83. *Id.* at 551.

84. *Id.* at 553-54.

85. *Id.* at 554. See 42 C.F.R. § 435.723(b)-(d) (1990) (regulating when a spouse's income is available).

86. The court also opined that the Secretary's "name-on-the-check" rule would violate 42 C.F.R. § 435.723(c)(1)(i), (d). *Bowen*, 815 F.2d at 555.

87. *Id.* at 555-56 (discussing Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 2373(c), 98 Stat. 1112).

88. *Id.* at 556.

89. 437 N.W.2d 686 (Minn. 1989).

90. *Id.* at 689 (discussing 42 U.S.C. § 1396a(a)(17)(B) (1988)).

deeming could apply.<sup>91</sup> The court also held that the Minnesota marital property division statutes applied only to those situations involving annulment, dissolution of marriage, or legal separation.<sup>92</sup>

Thus, in common-law property states such as Minnesota, the "name-on-the-check" rule appears to be an appropriate method for determining Medicaid financial eligibility for married couples when the primary wage earner is institutionalized. The question remains, however, whether the "name-on-the-check" rule will be used to determine Medicaid eligibility in common-law property states when the low income spouse is institutionalized and the high income spouse is not.

5. *Countable Income v. Actual Income*.—A Medicaid applicant's ability to satisfy the income test hinges on the level of the applicant's countable, as opposed to real, income.<sup>93</sup> Not all of an applicant's real income is necessarily considered to be "available income" for Medicaid eligibility purposes.<sup>94</sup> Only income that is received in cash or in kind and is available to meet the applicant's basic needs is considered to be income that counts toward inclusion in the income test for Medicaid eligibility.<sup>95</sup> Thus, an applicant's countable income is the income that is available to meet the applicant's needs.

Certain income amounts are not considered to be available to meet a person's basic needs. For example, assistance provided in cash or in kind under a federal, state, or local government program for the purpose of providing medical care or services is not considered to be countable income.<sup>96</sup> In *Mitson ex rel. Jones v. Coler*,<sup>97</sup> the court held that the portion of Veterans Administration (VA) pension benefits awarded to nursing home patients for reimbursed medical expenses does not constitute countable income for purposes of determining Medicaid eligibility.<sup>98</sup> The court concluded that the portion of the VA benefits at issue were reimbursement for the recipients' use of their non-VA income to pay for medical expenses.<sup>99</sup> Thus, because the recipients' non-VA income had already been diminished to pay medical expenses, the court reasoned

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91. *Id.* at 690. *See also* Washington Dep't of Social & Health Servs. v. Bowen, 815 F.2d 549, 555 (9th Cir. 1987) (Medicaid regulations place time limit on "deeming").

92. *Rindahl*, 437 N.W.2d at 693.

93. *See* 20 C.F.R. § 416.1102 (1990) (income is anything received in cash or in kind).

94. *Id.* § 416.1103 (defining what is not income).

95. 42 U.S.C. § 1396a(a)(17)(B) (1988); 20 C.F.R. § 416.1102 (1990) (income is food, clothing, shelter, or something that can be used to obtain food, clothing, or shelter).

96. 20 C.F.R. § 416.1103(a)(3).

97. 674 F. Supp. 851 (S.D. Fla. 1987).

98. *Id.* at 856.

99. *Id.* at 854.

that the VA benefits did not generate additional resources which were available to meet the recipients' basic needs.<sup>100</sup>

6. *Income Spend-down.*—Another issue concerning available income is the issue of income spend-down. States exercising the section 209(b) option must adopt a "spend-down" provision under which an individual whose income exceeds the applicable state standard can become eligible for Medicaid when that excess is spent on medical care.<sup>101</sup> SSI states have the option of utilizing income spend-down.<sup>102</sup> The purpose of spend-down provisions is to ensure the equitable treatment of the medically needy who may be as indigent as the categorically needy because of high medical expenses.<sup>103</sup>

For example, in *Hession v. Illinois Department of Public Aid*,<sup>104</sup> the court held that the federal Medicaid law required the Illinois Department of Public Aid to offset an applicant's medical bills by the amount of the applicant's excess savings, and to provide medical assistance for the remaining balance.<sup>105</sup> The applicant had incurred \$38,000 in medical bills during a three-month hospital stay, which exceeded his financial resources of less than \$2,000 in personal savings. The plaintiff applied for medical assistance as categorically "disabled" under SSI. Upon finding that the plaintiff had \$400 worth of savings above the eligibility limit, the Illinois agency denied the plaintiff *any* financial assistance.

Ruling for the plaintiff, the court held that the Medicaid statute permits state plans to utilize resource spend-down in determining an applicant's eligibility for medical assistance.<sup>106</sup> Thus, when individuals have financial resources that do not cover the cost of their health care, but that exceed the applicable income eligibility limits, Medicaid eligibility can be obtained once their "excess" income is applied to their medical bills. In other words, Medicaid benefits can be received once excess income is "spent-down" to the income eligibility limits.<sup>107</sup>

Similarly, in *Green v. Department of Public Aid*,<sup>108</sup> the plaintiff's application for medical assistance on behalf of her husband was denied

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100. *Id.*

101. Section 209(b) states are required to provide benefits to the medically needy (i.e., persons with incomes that are too high to qualify them as categorically needy). See *supra* note 28 and accompanying text.

102. See 42 C.F.R. § 435.301(a)(1)(ii) (1990) (income spend-down is also known as resource spend-down).

103. See, e.g., ILL. REV. STAT. ch. 23, para. 5-1 (Smith-Hurd 1988 & Supp. 1990).

104. 163 Ill. App. 3d 553, 516 N.E.2d 820 (1987), *aff'd*, 129 Ill. 2d 535, 544 N.E.2d 751 (1988).

105. *Id.* at 560, 516 N.E.2d at 824.

106. *Id.* at 559, 516 N.E.2d at 824.

107. *Id.* at 558, 516 N.E.2d at 824.

108. 165 Ill. App. 3d 936, 520 N.E.2d 860 (1988).

because the couple's joint available income exceeded the applicable income limit by \$26.36. The plaintiff had outstanding medical bills equaling \$150,000. Although the Department had provisions designed to permit medical assistance applicants to qualify for assistance by applying their excess income to their medical bills, the plaintiff was unaware of the procedures necessary to comply with the provisions. The court, holding that the defendant's income reduction policy was applied in an unconstitutional manner, noted that in order to satisfy the constitutional requirements of due process and fundamental fairness, applicants must be advised of the provision's procedural requirements.<sup>109</sup>

Likewise, in *Sipiora v. Illinois Department of Public Aid*,<sup>110</sup> the court held that the defendant's failure to inform the plaintiff of the existing income reduction policy *at the time of the plaintiff's initial application* for benefits resulted in an improper denial of medical benefits.<sup>111</sup> Similarly, in *Johnson v. Department of Public Aid*,<sup>112</sup> the plaintiff was also denied medical assistance because of excess income. In reversing the lower court's denial of medical benefits and remanding for a re-determination of the plaintiff's eligibility, the court ruled that the defendant *must* employ an income spend-down procedure *or* consider an applicant's medical expenses when determining eligibility.<sup>113</sup>

7. *Income Transfers*.—As mentioned above, a Medicaid applicant with excess available income can become eligible for Medicaid when the excess income is spent on medical care.<sup>114</sup> Conversely, persons with excess income cannot attain Medicaid eligibility by divesting themselves of the excess through voluntary transfers or gifts for the purpose of becoming eligible for Medicaid. Persons who transfer excess income within a specified time of applying for Medicaid raise a presumption that the transfer was made to obtain eligibility.<sup>115</sup> These persons may rebut the presumption by providing convincing evidence that the transfer was not for the purpose of qualifying for Medicaid.<sup>116</sup> Thus, it is important to understand the factors that can help a transferor overcome the presumption of a fraudulent conveyance.

In *Anson v. Kitchin*,<sup>117</sup> the petitioner was hospitalized for three weeks. During this hospitalization, the petitioner instructed his mother

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109. *Id.* at 941, 520 N.E.2d at 862-63.

110. 191 Ill. App. 3d 973, 548 N.E.2d 459 (1989).

111. *Id.* at 460.

112. 191 Ill. App. 3d 911, 548 N.E.2d 396 (1989).

113. *Id.* at 397.

114. See *supra* note 101 and accompanying text.

115. 20 C.F.R. § 416.1246(e) (1990).

116. *Id.*

117. 64 A.D.2d 752, 406 N.Y.S.2d 916 (1978).

to withdraw \$3,000 from his savings account and to use approximately \$1,600 of the withdrawn funds to pay an outstanding credit card bill. The petitioner instructed his mother to retain the balance as repayment for money advanced to him for repairs he was to make to his mother's home, but that he had never made. A few days later, the petitioner instructed his mother to apply for medical assistance on his behalf. The state agency determined that the entire \$3,000 was income available to the petitioner for medical expenses, and approved the petitioner's application only to the extent that his medical expenses exceeded the excess amount including the \$3,000.

In reviewing the agency's determination, the court noted that the applicant bears the burden of proving that an otherwise prohibited transfer was not made for the purpose of attaining eligibility, and that the purpose of creating such presumptions was to prevent fraudulent transfers.<sup>118</sup> The court reasoned that the petitioner could overcome the presumption of fraud by showing that the transfer was for value or was for repayment of an antecedent debt.<sup>119</sup> Applying this reasoning, the court held that the credit card debt was a valid debt incurred before hospitalization; therefore, the money used to pay it was not income available to the petitioner for medical expenses.<sup>120</sup> The court held, however, that the money initially advanced to the petitioner for repairs to his mother's home was merely a loan and was not a debt to perform work on her home.<sup>121</sup> Thus, the court included the amount of the loan in the computation for determining the income available for medical expenses.<sup>122</sup>

In *Downer v. Department of Human Resources*,<sup>123</sup> the plaintiff's ninety-year-old father transferred \$1,250 to the plaintiff and her husband to repay them for taking care of him and to help make repairs to their trailer. At the time of the transfer, the plaintiff's father was hospitalized and was facing imminent death. The plaintiff's father survived, however, and was placed in a nursing home.

Ten days after the transfer, the plaintiff filed for Medicaid benefits on her father's behalf under the Nevada Medicaid plan. The state agency denied the requested Medicaid benefits on the basis that the evidence was insufficient to rebut the presumption that the transfer was for the sole purpose of obtaining Medicaid eligibility, and the district court affirmed.

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118. *Id.* at 753, 406 N.Y.S.2d at 918.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. 101 Nev. 398, 705 P.2d 144 (1985).

The Nevada Supreme Court reversed the district court on two grounds. First, the court opined that because the plaintiff's father believed his death was imminent, he could not have anticipated at the time of the transfer that an application for Medicaid benefits would be filed on his behalf.<sup>124</sup> Second, the court noted that at the time of her father's death, the plaintiff and her husband had applied the entire amount of the transferred funds toward the decedent's medical bills.<sup>125</sup> The court thus remanded the case to the district court with instructions to recalculate the proper level of Medicaid benefits and to distribute them to the plaintiff and her husband.<sup>126</sup>

Similarly, the plaintiffs in *Rizzuto v. Blum*<sup>127</sup> closed a joint savings account containing almost \$15,000 and gave the funds to their sons, allegedly in consideration for the sons' performance of past services. Twenty days later, the plaintiffs applied for Medicaid. Upon discovering the former account's existence, which the plaintiffs had failed to indicate on their application, the state agency rejected the plaintiffs' request for benefits.

Unlike *Downer*, however, the *Rizzuto* court affirmed the state agency's denial of benefits.<sup>128</sup> Although the sons had applied part of the funds toward the plaintiffs' medical expenses, the court noted that excess income remained.<sup>129</sup> Furthermore, the court held that the excess income was available to the plaintiffs because they had retained control over the amount given to their sons.<sup>130</sup>

Similarly, in *Mitsch v. Perales*,<sup>131</sup> the state agency denied the petitioners' application for medical assistance on the ground that they had transferred \$30,000 to their son and daughter-in-law without compensation and within two years of the application date. The petitioners argued that the transfer was made pursuant to an oral agreement with their son to compensate him for the cost of building an extension onto the home where the petitioners would reside.

The court affirmed the state agency's denial of benefits even though the son completed the work. The petitioners moved into the addition, and were not in need of nursing home care at the time of the transfer. The court focused on the time lag between the date the son completed

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124. *Id.* at 399, 705 P.2d at 145.

125. *Id.*

126. *Id.*

127. 101 A.D.2d 699, 475 N.Y.S.2d 680 (1984).

128. *Id.* at 699, 475 N.Y.S.2d at 682.

129. *Id.* at 699, 475 N.Y.S.2d at 681.

130. *Id.* at 699, 475 N.Y.S.2d at 682.

131. 114 A.D.2d 369, 493 N.Y.S.2d 887 (1985).

the work and the transfer date, and ruled that a delay of approximately seven months colored the transfer as a gift.<sup>132</sup>

In *Brengola-Sorrentino v. Illinois Department of Public Aid*,<sup>133</sup> the plaintiff received a \$7,000 gift from her son-in-law to be used for her hip replacement surgery. The plaintiff used \$2,000 of the gift to pay for her surgery, with the balance remaining in her son-in-law's checking account. Due to a subsequent hip infection, the plaintiff was hospitalized a second time and applied for financial assistance to help defray her \$15,000 in outstanding medical bills. The county department denied the plaintiff's application because the plaintiff's available income, which included the \$7,000 gift, exceeded the Illinois income limit for single persons.

The court agreed with the county department's determination that the funds were income available to the plaintiff for payment of medical expenses, and noted that the son-in-law's testimony indicated that he intended to provide the balance of the gift to his mother-in-law only if no other funds were available to pay her medical expenses.<sup>134</sup> However, the court reversed the county department's decision to deny benefits because the department failed to notify the plaintiff of her opportunity to apply her excess income to her outstanding medical bills which would consequently qualify her for assistance once the excess was reduced to the applicable income limit.<sup>135</sup>

In *Probate of Marcus v. Department of Income Maintenance*,<sup>136</sup> two conservators applied for Medicaid benefits on their ward's behalf after making a series of gifts that totally depleted the ward's \$600,000 estate. The Department of Human Resources petitioned the probate court for an accounting of the estate's management, whereupon the probate court disallowed the gifts under Connecticut law. The Department of Income Maintenance adopted the probate court's decision, and disallowed the conservators' application.

The Connecticut Supreme Court affirmed the probate court's disallowance of the gifts for two reasons. First, in Connecticut, the probate court is responsible for the care and management of the ward's estate, whereas the conservator merely acts under the probate court's supervision and control as an agent of the court.<sup>137</sup> Thus, lacking a statute to

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132. *Id.*

133. 129 Ill. App. 3d 566, 472 N.E.2d 877 (1984).

134. *Id.* at 571, 472 N.E.2d at 880.

135. *Id.* at 573, 472 N.E.2d at 882.

136. 199 Conn. 524, 509 A.2d 1 (1986) (holding that probate court properly disallowed gifts for mother's estate because they were "actually available" to her).

137. *Id.* at 529, 509 A.2d at 2.

authorize the conservators' gifts, the probate court was forced to disallow them.<sup>138</sup> Second, the probate court disallowed the gifts because at the time of the gift, Connecticut did not follow the doctrine of substituted judgment.<sup>139</sup> The doctrine of substituted judgment permits the probate court to authorize gifts from a ward's estate for the sole purpose of avoiding unnecessary inheritance taxes or administrative expenses when it appears that the ward, if sane and reasonably prudent, would have made such gifts and when the gifts were made in accordance with the ward's testamentary intent.<sup>140</sup> Additionally, the effect of the probate court's disallowance of the gifts under Connecticut law was to impose personal responsibility on the conservators for the return of the unauthorized gifts to the estate.<sup>141</sup>

*Marcus* raises interesting questions for estate planners. For instance, planners must determine how broad a conservator's powers are in their state and whether their state follows the doctrine of substituted judgment. Similarly, planners must understand the potential impact that a probate court's decision might have on predecision acts of the conservator in their state.

In summary, excess income cannot be transferred or given as a gift to qualify for Medicaid benefits. If such a transfer occurs *within* a specified time before the transferor's application for Medicaid benefits, a presumption will be raised that the transfer was made to obtain Medicaid eligibility. A transferor can overcome the presumption if the transfer was made to pay a valid antecedent debt, the transferor relinquished control over the transferred funds, the excess transferred funds have been applied to medical expenses, or if the transfer was for full compensation, thus becoming payment for a valid debt due and owing. Similarly, if the transfer was made for services rendered, a significant and unreasonable time lag between performance and compensation must not exist. Transfers made in contemplation of death where the transferor lives and later applies for benefits are also likely to overcome the presumption of fraud.

A transferor will be unable to overcome the presumption of fraud if the transfer is for less than full compensation or if the transferee neither expected nor requested repayment. Likewise, a transferor will be ineligible for Medicaid if a transferee applies transferred funds to the transferor's medical expenses, but applies less than an amount necessary to eliminate all excess income. Also, retaining control over transferred funds tends to turn those funds into income available for the payment

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138. *Id.* at 527, 509 A.2d at 4.

139. *Id.* at 528, 509 A.2d at 4.

140. *Id.* at 530, 509 A.2d at 4. *See also* UNIF. PROBATE CODE § 5-408 (1977).

141. *Marcus*, 199 Conn. at 524, 509 A.2d at 5.

of medical expenses. Additionally, conservators who transfer or make gifts of estate funds in states that grant limited powers to conservators or that decline to follow the doctrine of substituted judgment are not likely to obtain Medicaid benefits for the ward.

8. *The Medicare Catastrophic Coverage Act of 1988 (MCCA).*—In 1988, Congress amended portions of the Medicaid statute, thereby affecting Medicaid financial eligibility requirements.<sup>142</sup> These amendments only apply when an institutionalized spouse is married to a spouse in the community (the community spouse).<sup>143</sup> They also contain separate provisions regarding income and assets.<sup>144</sup> Thus, the new amendments should be of concern to couples facing an anticipated or potential institutionalization of one of the spouses.<sup>145</sup>

The MCCA income provisions became effective September 30, 1989, and apply to individuals institutionalized on or after that date, including institutionalized individuals currently receiving Medicaid.<sup>146</sup> The income provisions provide that except for the potential attribution of joint income, none of the community spouse's income is deemed available to the spouse during any month in which that spouse is in an institution.<sup>147</sup> Yet, whether money held in a savings account in the community spouse's name will remain income unavailable to the Medicaid applicant is unclear.<sup>148</sup>

The MCCA sets forth attribution rules for two types of income: nontrust income and income without an instrument establishing ownership.<sup>149</sup> With respect to nontrust income, the "name-on-the-check" rule

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142. The Medicare Catastrophic Coverage Act of 1988, Pub. L. No. 100-360, 102 Stat. 748 [hereinafter MCCA].

143. *Id.*

144. *Id.*

145. Under the MCCA, an institutionalized spouse is defined as: an individual who (A) is in a medical institution or nursing facility or who (at the option of the State) is described in § 1902(a)(10)(A)(ii)(VI), and (B) is married to a spouse who is not in a medical institution or nursing facility; but does not include any such individual who is not likely to meet the requirements of subparagraph (A) for at least 30 consecutive days.

42 U.S.C. § 1396r-5(h)(1)(A) (1988). The term "community spouse" remains unchanged, and means the spouse of an institutionalized spouse. *Id.* § 1396r-5(h)(2).

146. *Id.* § 1396r-5(b)(2)(A)(ii).

147. *Id.* § 1396r-5.

148. Income held in a *joint* savings account will generally be classified as income available to the Medicaid applicant. Upon creation of a joint account, the joint tenants are presumed to be one-half owners of the deposited funds. The presumption is effective upon creation of the account, and the burden is upon the party challenging it to rebut the presumption. *See Zagoreos v. Zagoreos*, 81 A.D.2d 890, 891, 439 N.Y.S.2d 155, 156 (1981).

149. 42 U.S.C. § 1396r-5(h)(2)(A) (1988).

applies.<sup>150</sup> Thus, income is attributed solely to the spouse in whose name the income is received.<sup>151</sup> Similarly, one-half of all joint income is considered available to each spouse.<sup>152</sup> Likewise, any income made payable to both spouses and to any other person is considered available to each spouse in proportion to the spouse's interest.<sup>153</sup> Regarding any income a couple receives that is not made payable to any particular person, one-half of such income is considered available to both the institutionalized spouse and the community spouse.<sup>154</sup> These income attribution rules apply regardless of any state community property or marital division laws,<sup>155</sup> and are rebuttable if an institutionalized spouse can establish by a preponderance of the evidence that his or her ownership interests differ from the provisions.<sup>156</sup>

The MCCA also provides that when possible, the community spouse is to receive income of at least: (1) 122% of the federal poverty level for a couple effective September 30, 1989; (2) 133% of the federal poverty level for a couple effective July 1, 1991; or (3) 150% of the federal poverty level for a couple effective July 1, 1992.<sup>157</sup> Community spouses may also be entitled to an excess shelter allowance.<sup>158</sup> Additionally, a community spouse is entitled, subject to adjustment, to a monthly maintenance allowance from the institutionalized spouse of not more than \$1,500 per month if the money is needed to permit the community spouse to maintain the level of income he or she is to receive.<sup>159</sup>

The MCCA also requires states to honor court orders for support of the community spouse, and these court orders are not subject to the monthly maintenance allowance limit of \$1,500.<sup>160</sup> The amount of money that a court orders for spousal maintenance, however, will not be deducted from a medically needy applicant's total income.<sup>161</sup> In *Clark v. Commissioner of Income Maintenance*,<sup>162</sup> the plaintiff applied to the probate court for a monthly allowance from her husband's estate. The probate court granted her a monthly allowance exceeding her request,

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150. See *id.* § 1396r-5(b)(2)(A)(i).

151. *Id.*

152. *Id.* § 1396r-5(b)(2)(A)(ii).

153. *Id.* § 1396r-5(b)(2)(A)(iii).

154. *Id.* § 1396r-5(b)(2)(A)(ii).

155. *Id.* § 1396r-5(c)(2).

156. *Id.* § 1396r-5(b)(2)(D).

157. *Id.* § 1396r-5(d)(3)(B)(i)-(iii).

158. *Id.* § 1396r-5(d)(4).

159. *Id.* § 1396r-5(d)(3)(C).

160. *Id.* § 1396r-5(d)(5).

161. See *infra* note 164 and accompanying text.

162. 209 Conn. 390, 551 A.2d 729 (1988).

but did not deduct this amount from the computation of her husband's available income. The plaintiff appealed the probate court's determination, arguing that the monthly allowance was not "available" to the husband because the court order obligated the husband to pay the amount to a third party. The trial court ruled for the plaintiff, and the state appealed.

The Connecticut Supreme Court reversed the trial court, holding that the state agency could not consider a probate court order for spousal support in determining a Medicaid applicant's eligibility for Medicaid.<sup>163</sup> In reaching this decision, the court noted that the applicable federal regulation specifically listed four amounts that a state agency may deduct from a medically needy applicant's total income, and that these enumerated amounts did not include court orders for spousal support.<sup>164</sup> The court concluded that because the Secretary's regulations already provided for an agency-determined spousal support exclusion, the court-ordered amount of support was properly included in the computation of the husband's available income.<sup>165</sup>

### C. Asset Test

1. *General provisions.*—To qualify for Medicaid, an applicant may possess only a limited amount of assets. Each participating state sets its own asset limit and determines which assets are counted toward this limit. If an applicant possesses assets exceeding the applicable asset limit, the applicant will be required to spend-down the excess income before he or she will be eligible for Medicaid.

The 1988 MCCA amendments made critical changes to the federal Medicaid statute concerning the computation of an applicant's available assets and restrictions on asset transfers.<sup>166</sup> These changes are the basis for present and future planning, and have the greatest impact on married couples when one spouse is receiving long-term institutional care in a nursing home and the other spouse remains in the community.

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163. *Id.* at 397, 551 A.2d at 732-33.

164. *Id.* at 398-402, 551 A.2d at 733. A state agency may deduct the following amounts from a medically needy applicant's total income: (1) a personal needs allowance; (2) an at-home spousal allowance; (3) an at-home family allowance; and (4) medical or remedial expenses not paid by third parties. 42 C.F.R. § 435.832(c) (1990).

165. *Clark*, 209 Conn. at 404, 551 A.2d at 736. Similarly, in *Johnson v. Flanagan*, 179 Ga. App. 708, 347 S.E.2d 643 (1986), the court ruled that court-ordered alimony payments may not be deducted from the computation of a Medicaid applicant's available income.

166. The MCCA regulations apply only to those persons beginning a continuous period of institutionalization on or after September 30, 1989. 42 U.S.C. § 1396r-5(d)(3)(B)(i) (1988).

2. *Computing an Applicant's Available Assets.*—At the time of an initial Medicaid eligibility determination, the MCCA provides for a one-time computation of the nonexempt assets of both the institutionalized spouse and the community spouse.<sup>167</sup> The total fair market value of these assets is considered available to the institutionalized spouse for eligibility purposes, regardless of any state laws relating to community property or the division of marital property.<sup>168</sup> A spousal share equivalent to one-half of the total value of the combined assets is also computed at the time of the initial Medicaid eligibility determination.<sup>169</sup> During the continuous period of institutionalization and after the month in which the institutionalized spouse is determined to be eligible for Medicaid, none of the community spouse's assets are deemed available to the institutionalized spouse.<sup>170</sup>

While the combined value of both spouses' assets is deemed available to the institutionalized spouse for Medicaid eligibility purposes, an exception to this rule permits the community spouse to retain a spousal share of assets worth up to \$60,000.<sup>171</sup> The community spouse's assets that do not exceed the prescribed amount at the time the institutionalized spouse applies for Medicaid will not be considered to be available to the institutionalized spouse for eligibility purposes.<sup>172</sup> Thus, under the exception, the institutionalized spouse must deplete his or her own spousal share down to the nonexempt asset limit, and the community spouse must deplete his or her spousal share down to the spousal share asset limit before the institutionalized spouse can receive Medicaid benefits.

For example, assume X and Y are an older farm couple with nonexempt assets consisting of land, machinery, buildings, and livestock totalling \$2,000,000. X is afflicted with Parkinson's Disease and will require institutionalization within a year. Under the MCCA, both X and Y are considered to have a spousal share of \$1,000,000 regardless of how the assets are divided between X and Y. X must exhaust all but \$1,600 (the nonexempt asset limit) of X's assets, and Y must exhaust all but \$60,000 before X becomes eligible for Medicaid.<sup>173</sup>

If the total combined value of the assets is such that the spousal share is less than \$12,000, the MCCA permits the institutionalized spouse to transfer assets to the community spouse to allow the community

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167. *Id.* § 1396r-5(c)(1)(A)(i).

168. *Id.* § 1396r-5(c)(2)(A).

169. *Id.* § 1396r-5(c)(1)(A)(ii).

170. *Id.* § 1396r-5(c)(4).

171. *Id.* § 1396r-5(f)(2)(A)(ii).

172. *Id.* § 1396r-5(c)(2)(B).

173. If Y subsequently acquires or inherits assets in Y's name, Y will be permitted to keep the assets and will not be required to contribute toward X's medical care.

spouse to hold at least \$12,000 in nonexempt assets.<sup>174</sup> At their discretion, participating states may permit transfers allowing the community spouse to hold up to \$60,000, but the community spouse is guaranteed a spousal asset share worth \$12,000.<sup>175</sup> Additionally, an affected person who believes that the determination of the spousal share or resource attribution is incorrect, or who believes that the community spouse resource allowance is inadequate to raise the community spouse's income to the applicable limit, may request a hearing.<sup>176</sup>

3. *Asset Transfers.*—Because the cost of long-term institutional care is high, persons anticipating a need for long-term care may face a strong temptation to transfer or to give away excess assets to qualify for Medicaid benefits.<sup>177</sup> In an attempt to prevent potential Medicaid applicants from deliberately divesting themselves of excess assets in order to qualify for Medicaid benefits, participating states have enacted statutes and regulations that deny benefits to applicants who transfer assets during a specified time period with the intent of qualifying for Medicaid. Yet, because the federal government partially funds state Medicaid benefits, the applicable governing federal Medicaid laws, combined with the constitutional constraints of due process and equal protection, limit the participating states' power to regulate asset transfers.

Before 1980, a federal regulation permitted the categorically needy to transfer assets that, if retained, would have disqualified them from receiving cash assistance and hence, Medicaid benefits.<sup>178</sup> Similarly, categorically needy individuals could give away or sell assets for less than adequate consideration and remain eligible for SSI. No similar federal regulation applied to the medically needy. Rather, various state rules denied Medicaid benefits to medically needy applicants who divested themselves of assets within a specified time before applying for Medicaid. This divergence between the federal rule and state rules culminated in the Social Security Amendments of 1980, commonly known as the Boren-Long Amendment (Amendment).<sup>179</sup>

The Amendment created a presumption that any asset owned by an

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174. 42 U.S.C. § 1396r-5(f)(2)(A)(i) (1988).

175. *Id.* § 1396r-5(f)(1), (2).

176. *Id.* § 1396r-5(e)(2)(A).

177. To the extent that divesting occurs, the costs of the Medicaid program are increased because public funds are paying for medical expenses that could have been met from the individual's assets.

178. 20 C.F.R. § 416.1240 (1990). *See, e.g.*, *Sinclair v. Department of Health & Social Servs.*, 77 Wis. 2d 322, 253 N.W.2d 245, 250 (1977) (categorically needy persons applying for Medicaid are not ineligible if they sell their assets within two years of their application for benefits).

179. Pub. L. No. 96-611, § 5, 94 Stat. 3567 (1980).

applicant or an applicant's spouse that was disposed of for less than its fair market value within two years of an application for SSI is included in the applicant's resources if the asset was disposed of in order to establish eligibility for SSI.<sup>180</sup> The Amendment specifies that the amount included in the applicant's resources is to be the asset's fair market value at the time of the transfer, less any compensation received.<sup>181</sup> An applicant can overcome the presumption with convincing evidence that the transfer was made exclusively for a purpose other than to establish eligibility.<sup>182</sup>

The Amendment also expressly allows state Medicaid plans to apply similar rules to Medicaid recipients, including both the categorically needy and the medically needy.<sup>183</sup> Additionally, the Amendment specifies that state procedures for determining Medicaid eligibility may be no more restrictive than the federally mandated SSI procedure, subject to one exception. The exception permits states to delay eligibility for more than two years if the transferred asset's fair market value at the time of the transfer less compensation received exceeds \$12,000.<sup>184</sup>

The MCCA applies to transfers completed on or after July 1, 1988 and changes the prior twenty-four-month rule regarding asset transfers for less than fair market value to a thirty-month rule.<sup>185</sup> Specifically, the MCCA provides that an institutionalized Medicaid *applicant* who, at any time during the thirty-month period immediately preceding the individual's application, disposes of assets for less than fair market value is subject to a period of ineligibility.<sup>186</sup> The period of ineligibility is defined as the period of time up to thirty months that is needed to

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180. *Id.* § 5(a)(c)(1), (2). For example, assets transferred in order to qualify for Medicaid are "available" to the transferor. *See* *Harrison v. Commissioner*, 204 Conn. 672, 529 A.2d 188, 192 (1987). Similarly, unauthorized gifts by a conservator are "available" to the ward. *See* *Probate of Marcus v. Department of Income Maintenance*, 199 Conn. 524, 509 A.2d 1 (1986).

181. Pub. L. No. 96-611, § 5(a)(c)(3).

182. *Id.* § 5(a)(c)(2).

183. *Id.* § 5(a)(c)(3).

184. *Id.* § 5(a)(c)(3)(b)(2).

185. 42 U.S.C. § 1396p(c)(1)(A) (1988).

186. *Id.* One may query whether the *community* spouse to transfer the couple's assets for less than fair market value within 30 months of the institutionalized spouse's Medicaid application. Additionally, because assets acquired by the community spouse after the institutionalized spouse has established Medicaid eligibility will not be considered, the MCCA appears to permit asset transfers to a third party more than 30 months before the initial Medicaid application. The assets are then transferred back to the community spouse after Medicaid eligibility has been established for the institutionalized spouse. On the other hand, assets held by a child or other third party arguably would be treated as being held in constructive trust for the community spouse.

spend the uncompensated value of the transferred assets on nursing home care in the applicant's state or community.<sup>187</sup>

Like the previous law, the MCCA provides that transfers of non-exempt assets occurring within the thirty-month period will be excused if a satisfactory showing is made that the applicant intended to dispose of the assets either at fair market value or for other valuable consideration, or that the assets were transferred exclusively for a purpose other than to qualify for medical assistance.<sup>188</sup> Likewise, an otherwise prohibited transfer will be set aside if the state determines that denying eligibility will cause undue hardship.<sup>189</sup> Unlike previous law, however, otherwise prohibited transfers of assets to or for the sole benefit of the community spouse will not result in the transferor-applicant's ineligibility.<sup>190</sup>

For courts deciding whether an applicant is ineligible for benefits due to asset transfers or whether an applicant has excess available assets, the circumstances giving rise to the applicant's present inability to meet medical expenses are the determinative factor. Similar to the income transfer cases, important factors for a court's consideration are the transferor-applicant's knowledge at the time of the transfer that future medical assistance would be required, whether assets were transferred to a relative or a nonrelative, and the amount of consideration received for any transferred assets.<sup>191</sup> Alternatively, transfers of exempt assets are not prohibited,<sup>192</sup> but planners must recognize that the list of exempt assets varies from state to state.<sup>193</sup>

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187. *Id.* § 1396p(c)(1)(B).

188. Thus, nonexempt assets may be transferred within the 30-month period for less than fair market value without making the transferor ineligible for Medicaid benefits if the transferor can show that the assets were not transferred "in contemplation of Medicaid." *Id.* § 1396p(c)(2)(C).

189. *Id.* § 1396p(c)(2)(C), (D).

190. *Id.* § 1396p(b)(c)(2)(B).

191. *Id.*

192. See, e.g., *Beltran v. Myers*, 677 F.2d 1317 (9th Cir. 1982); *Brown v. Toia*, 59 A.D.2d 1044, 399 N.Y.S.2d 796 (1978) (applicant who transferred home to children without consideration is eligible for Medicaid).

193. Planners must also note that the proceeds from the sale of exempt assets may be included in the computation of a Medicaid applicant's available income. For example, the court in *Moran v. Lascaris*, 61 A.D.2d 405, 402 N.Y.S.2d 486 (1978) held that the proceeds from the sale of an exempt homestead, when the sale is to an unrelated third party for valuable consideration, constitutes an available resource relevant to the recipient's continued medical assistance eligibility. Similarly, in *McManus v. D'Elia*, 66 A.D.2d 783, 410 N.Y.S.2d 655 (1978), the petitioner conveyed her home to a third party for \$30,000. While the court noted that other courts have held that a transfer made to satisfy an antecedent debt owing to the grantee rebuts the presumption that the transfer was made for the purpose of qualifying for medical benefits, it also noted that the petitioner received

In *Saviola v. Toia*,<sup>194</sup> an applicant for medical assistance successfully overcame the presumption that a transfer of assets was made for the purpose of attaining eligibility. The court held that the applicant provided sufficient evidence that the transfer was made when the applicant was in good health and did not contemplate a future need for assistance.<sup>195</sup>

Similarly, in *Yiotis v. D'Elia*,<sup>196</sup> the court held that the petitioner presented sufficient evidence to rebut the presumption that the \$4,200 in assets she transferred within a year of her initial application for medical assistance was for the purpose of qualifying for medical assistance.<sup>197</sup> The court noted that the testimony of the petitioner's daughter established that the transfers were for valid reasons and were founded on fair consideration.<sup>198</sup> Additionally, the expert testimony of the petitioner's physician indicated that the petitioner had no reason to believe that she was in imminent need of medical assistance or nursing home care at the time of the transfers.<sup>199</sup>

In *North Shore University Hospital v. D'Elia*,<sup>200</sup> an applicant for medical assistance transferred real property to a corporation in which the applicant and her husband were the sole principals. The court held that a prohibited transfer had not occurred because the applicant continued to receive the same benefits and use of the property as she had before the title transfer.<sup>201</sup>

A third person's transfer of assets on behalf of a medical assistance applicant is unlikely to disqualify the applicant from receiving benefits if the third person acted independently in transferring the assets. In *Zybach v. Nebraska Department of Social Services*,<sup>202</sup> the son of an

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the proceeds of the sale. Hence, the court held that the conversion of the homestead into cash removed the exemption and made the proceeds income available to the petitioner for medical eligibility purposes.

194. 63 A.D.2d 849, 405 N.Y.S.2d 854 (1978).

195. *Id.* at 850, 405 N.Y.S.2d at 856.

196. 76 A.D.2d 885, 428 N.Y.S.2d 714 (1980).

197. *Id.* at 885, 428 N.Y.S.2d at 715.

198. *Id.*

199. *Id.* While injuries and other physical maladies that require hospitalization and occur a significant time before an asset transfer may increase the likelihood of an individual's need for medical care, prior injuries or hospitalization must be related to present physical conditions in order to disqualify a medical assistance applicant from benefits due to a prohibited asset transfer. See *Prezioso v. Amrhein*, 154 A.D.2d 468, 545 N.Y.S.2d 939 (1989). Similarly, a medical assistance applicant need not be in perfect health at the time an asset transfer is made in order to overcome the presumption that the transfer was made for the purpose of qualifying for benefits. A serious disability may be required. *Albert v. Perales*, 156 A.D.2d 619, 620, 549 N.Y.S.2d 426, 427 (1989).

200. 79 A.D.2d 605, 433 N.Y.S.2d 495 (1980).

201. *Id.* at 606, 433 N.Y.S.2d at 496.

202. 226 Neb. 396, 411 N.W.2d 627 (1987).

applicant for medical assistance, acting as his mother's attorney-in-fact, sold his mother's farmland and distributed the proceeds among himself, his wife, and his sister. The state agency denied medical assistance benefits on the basis that the transfer violated a state statute that declared an applicant to be ineligible if the *applicant* is deprived of assets either by giving away or disposing of assets for less than fair market value for the purpose of qualifying for assistance. The district court reversed the agency's determination, and the agency appealed.

On appeal, the Nebraska Supreme Court opined that the statutory disqualifying act was the act of depriving oneself of resources "for the purpose of qualifying for assistance," and that "purpose" means an intention requiring intelligence in seeking a desired result.<sup>203</sup> The court noted that when the applicant allegedly acted with the "purpose of qualifying for assistance," she was ninety-four years old, incompetent, and had resided in a nursing home for twelve years.<sup>204</sup>

Thus, the court reasoned that the applicant never had sufficient mental capacity to transfer assets with the intent and purpose of qualifying for assistance.<sup>205</sup> Additionally, the court concluded that because the son did not have the implied or apparent authority to act as a principal, the applicant did not act through her son.<sup>206</sup>

The presumption that an applicant for medical assistance transferred assets for the purpose of qualifying for medical assistance can also be overcome if the applicant establishes that the transfers were made to avoid probate. For example, in *Meier v. State*,<sup>207</sup> the petitioner deeded a one-half interest in her home to her son and daughter for one dollar. A second daughter was to receive one-third of the value of the petitioner's home. The petitioner also executed a power of attorney, authorizing her son and daughter to serve as her attorneys-in-fact. Less than four months after the conveyance, the petitioner collapsed, was hospitalized, and was thereafter transferred to a nursing home. The petitioner applied for medical assistance soon after entering the nursing home.

Although the petitioner was diagnosed as having a mild case of Parkinson's and Alzheimer's diseases approximately nine months before she collapsed, neither the petitioner nor her family were informed of the diagnoses until after she collapsed. Testimony at trial established that the petitioner transferred her home in order to be free of the responsibilities of ownership and because she wanted someone to live with her.<sup>208</sup> Trial testimony also established that the petitioner's family

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203. *Id.* at 403, 411 N.W.2d at 631.

204. *Id.*

205. *Id.* at 403, 411 N.W.2d at 632.

206. *Id.*

207. 227 Neb. 376, 417 N.W.2d 771 (1988).

208. In fact, one week before the petitioner's collapse, new furniture was purchased

had a history of taking care of its kin without resort to nursing homes or public assistance. Based on these findings and the fact that the petitioner's lawyer wrote that the power of attorney was executed to avoid a conservatorship, and the fact that the deed was executed to avoid probate, the court held that the petitioner had overcome the presumption that she had transferred assets in order to become eligible for medical assistance benefits.<sup>209</sup>

In *Rinefierd v. Blum*,<sup>210</sup> however, the court determined that sufficient evidence was not presented to overcome the presumption that the petitioner had transferred assets for the purpose of qualifying for medical assistance.<sup>211</sup> In *Rinefierd*, nine months after entering a nursing home, the petitioner sold his home and distributed the proceeds to his five sons. One year later, the petitioner applied for medical assistance. The court, in upholding the state agency's denial of benefits, noted that the petitioner had an established medical need and had virtually no hope of leaving the nursing home when he sold his home.<sup>212</sup>

Several courts have dealt with the issue of whether a surviving spouse's waiver of the right to take against the deceased spouse's will constitutes a prohibited transfer of assets for less than fair market value, thereby disqualifying the surviving spouse from receiving medical assistance benefits. For example, in *Bradley v. Hill*,<sup>213</sup> a surviving spouse waived her marital rights to take against her deceased husband's will. The court held that a prohibited asset transfer had occurred.<sup>214</sup> The court reasoned that the surviving spouse has a personal and nontransferable right to take against her husband's will, but that the surviving spouse does not enjoy this benefit unless proper application has been made with the probate court and the probate court enters appropriate orders of allowance.<sup>215</sup>

Likewise, in *Stamer v. Estate of Wright*,<sup>216</sup> the court held that a surviving spouse's right to take under a deceased spouse's will does not ripen into actual ownership and possession without an order of the probate court.<sup>217</sup> The court also noted that although exempt property becomes the absolute property of a widow upon the death of the spouse,

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for her and improvements were made to her home in preparation for her daughter to move into the home.

209. *Meier*, 227 Neb. at 384-85, 417 N.W.2d at 778.

210. 66 A.D.2d 351, 412 N.Y.S.2d 526 (1979).

211. *Id.* at 353, 412 N.Y.S.2d at 528.

212. *Id.*

213. 457 S.W.2d 212 (Mo. App. 1970).

214. *Id.* at 216.

215. *Id.* at 214.

216. 701 S.W.2d 789 (Mo. App. 1985).

217. *Id.* at 790.

title to exempt property does not vest absent an order of the probate court.<sup>218</sup>

4. *Asset Valuation.*—At the heart of the asset test is the issue of asset valuation. Asset valuation is important not only to those individuals who transfer assets for less than fair market value during the thirty-month period, but also to persons who are trying to determine whether the value of their assets exceeds the applicable asset limit. For purposes of the asset test, the MCCA states that the proper measure of an asset's value is its fair market value.<sup>219</sup> Courts have defined fair market value as the price a willing buyer will pay to a willing seller, rather than the appraised value of the asset or a figure derived from a table based on the asset's appraised value.<sup>220</sup> However, appraisals are typically used to value farmland.<sup>221</sup> Thus, a court's reluctance to use asset appraisal values as a measure of an asset's market value for Medicaid eligibility purposes may create problems for farm couples facing the potential institutionalization of one of the spouses and needing to determine, for estate planning purposes, how much value the state agency is likely to attribute to their nonexempt farmland.

In *Estate of Pearl v. Director, Missouri State Division of Welfare*,<sup>222</sup> the Missouri Court of Appeals held that the market value of a parcel of real estate "may be estimated according to the uses for which it is suitable, with due regard to existing or community wants."<sup>223</sup> Hence, only the highest and best use to which a parcel of real estate is adaptable constitutes an element of present value.<sup>224</sup> This opinion implies that land suited for agricultural use is to be valued according to its highest and best use as agricultural land.

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218. *Id.* See also *In re Estate of Savage*, 650 S.W.2d 346, 351 (Mo. App. 1983) (holding that the statutory share that a surviving spouse may take upon renunciation of a will does not automatically vest upon the decedent's death).

219. 42 U.S.C. § 1396p(b)(c)(1) (1988). Interestingly, one court has ruled that the market value of gas lease royalties is the market value of the gas as marketed under a 20-year gas sale contract and not the current market value. *See Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334, 1338 (La. 1982).

220. *E.g.*, *Brumit v. State Dep't of Pub. Health & Welfare*, 521 S.W.2d 445 (Mo. 1975); *Davis v. State Dep't of Pub. Health & Welfare*, 483 S.W.2d 775 (Mo. 1972).

221. Appraisals are used for agricultural land because no continuous market exists that provides information about the value of a given parcel of farmland. Similarly, due to the lack of homogeneity among farmland parcels, relying on the price information from other farmland sales to make value estimates for a given farmland parcel is difficult. *See W. MURRAY, D. HARRIS, G. MILLER, & W. THOMPSON, FARM APPRAISAL* 3-21 (1983) [hereinafter *FARM APPRAISAL*].

222. 538 S.W.2d 922 (Mo. App. 1976).

223. *Id.* at 926.

224. *Id.*

Another Missouri case, *Hill v. State Department of Public Health and Welfare*,<sup>225</sup> focused on the issue of what constitutes "fair and valuable consideration" under the Missouri statutory definition. The court held that a verbal promise to pay in the future, accompanied by sufficient part performance on the seller's behalf, satisfied the Missouri statute.<sup>226</sup> Thus, according to the court, an unsecured oral promise to pay can be consideration approximately equal to the value of the property so long as the promisor is not insolvent and the promise to pay is enforceable.<sup>227</sup> Planners facing a similar statutory definition of "fair and valuable consideration" may find *Hill* useful in rebuffing claims that a client who has sold farmland, but who has not yet received payment, sold the land for less than fair market value.

Perhaps an appropriate and consistent method for valuing farmland for Medicaid eligibility purposes is the market data approach. The market data approach involves a comparison of the subject property with other properties sold in the farmland market in order to estimate what the subject property would bring upon sale.<sup>228</sup> Although the shortage of sales of comparable farmland poses a serious difficulty with the market data approach, the approach can be useful in arriving at a fair market value estimate of agricultural land when combined with other information concerning the income and cost structure of the particular parcel.<sup>229</sup>

Two recent cases, also in Missouri, concern the issue of valuing personal property subject to restraints on alienation. In *Williams v. Missouri Department of Social Services*,<sup>230</sup> the petitioner claimed that a \$31,500 nonassignable promissory note payment, and payable at \$175 per month without interest over 180 months, lacked value because the note's nonassignability feature deprived it of *any* market value.<sup>231</sup> The court disagreed, and ruled that when a security cannot be assigned due to a legal impediment, yet still has an economic value to its owner, the finder of fact may consider "other" factors to determine value.<sup>232</sup>

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225. 503 S.W.2d 6 (Mo. 1973).

226. *Id.* at 11 (construing Mo. Rev. Stat. § 208.010.2(1)(a) (1969)).

227. *Id.* at 12.

228. The process of estimating sale value involves four steps: (1) defining the type of sale to be used; (2) selecting and analyzing nearby sales; (3) determining the comparability of the farmland sold to the subject property; and (4) adjusting value for differences in characteristics between the sale properties and subject property. *FARM APPRAISAL*, *supra* note 221, at 26.

229. Another interesting possibility for valuing farmland is the use of tax assessments. See *Harris v. Lukhard*, 547 F. Supp. 1015 (W.D. Va. 1982), *aff'd*, 733 F.2d 1075 (4th Cir. 1984) (approving the state's use of assessments to establish the value of a parcel of real estate for Medicaid eligibility purposes).

230. 718 S.W.2d 193 (Mo. App. 1986).

231. *Id.* at 194.

232. *Id.* at 195.

In *Wiser v. Division of Family Services*,<sup>233</sup> a Missouri medical assistance applicant and her ex-husband sold a parcel of Florida real estate for \$17,000. The buyers paid \$5,000 and financed the balance with a promissory note secured by a deed of trust that specified that the buyers were to pay monthly installments of \$157. In 1986, the secured note was awarded to the claimant in a dissolution proceeding. A Missouri banker stated in a letter that the note had little or no value in Missouri, but that it might be of value in Florida, even though the note still had \$8,700 due and a discounted value of \$6,405.60.

The court rejected the banker's opinion, and determined that the note was a resource available to the petitioner because it was marketable in Florida.<sup>234</sup> The court also opined that a review of the record showed that the note was worth more than the statutory minimum of \$999.99.<sup>235</sup> Thus, the court upheld the trial court's denial of medical assistance benefits.<sup>236</sup>

5. *Validity of State Transfer-of-Asset Statutes.*—Estate planners and counselors for persons denied Medicaid benefits may want to consider challenging the validity of the particular state statute or regulation authorizing the denial. Many states' "transfer-of-assets" statutes have been invalidated either under the supremacy clause as contrary to controlling federal law, or under the due process clause as creating an irrebuttable presumption that a transfer of assets was made for the purpose of attaining Medicaid eligibility.

In general, a state transfer-of-assets statute will overcome a supremacy clause challenge if it is not more restrictive than the federal transfer-of-assets rule in determining asset availability.<sup>237</sup> Likewise, in order to overcome a due process challenge, a state transfer-of-assets statute must focus on preventing asset transfers for the purpose of qualifying for assistance, and must expressly set out the requirements for overcoming the presumption that an otherwise permissible transfer was made for the purpose of attaining eligibility.<sup>238</sup> Particular states may also be required to establish administrative hearing procedures for handling applicant appeals.<sup>239</sup>

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233. 754 S.W.2d 35 (Mo. App. 1988).

234. *Id.* at 36.

235. *Id.*

236. *Id.*

237. *E.g.*, Beltran v. Myers, 677 F.2d 1317 (9th Cir. 1982); Robinson v. Pratt, 497 F. Supp. 116 (D. Mass. 1980).

238. *E.g.*, Lavine v. Milne, 424 U.S. 577 (1976); Dawson v. Myers, 622 F.2d 1304 (9th Cir. 1980).

239. See *Fabula v. Solomon*, 463 F. Supp. 830, 838 (D. Md. 1978), *rev'd sub nom. Fabula v. Buck*, 598 F.2d 869 (4th Cir. 1979) (state must adhere to federal requirements).

In *Deel v. Jackson*,<sup>240</sup> the court upheld a Virginia transfer-of-assets rule as a reasonable means of identifying improper transfers when the rule was aimed at transfers made for the purpose of receiving benefits to which the applicant was not entitled and required applicants to provide evidence that other resources were available to meet their needs at the time of the transfer.<sup>241</sup> In *Deel*, the plaintiff transferred fifty-nine acres of land for less than fair market value two days before applying for AFDC benefits. The state agency denied the plaintiff's application. The plaintiff argued that the Virginia "transfer-of-assets rule violated the 'availability principle' derived from the Social Security Act, which requires that only assets currently available to an applicant may be considered in determining eligibility."<sup>242</sup>

The court reasoned that although the availability principle prevents states from denying benefits on the basis of income or resources imputed to an applicant that are not available for the applicant's use, the transfer-of-assets rule deals with applicants who owned property but who chose to give it away in order to qualify for undeserved benefits.<sup>243</sup> Thus, the court ruled that the availability principle is not a clear-cut rule of literal availability and that its scope does not extend to the Virginia transfer-of-assets rule.<sup>244</sup>

In a case directly involving Virginia's Medicaid program, the district court in *Mowbray v. Kozlowski*<sup>245</sup> held that Virginia's Medicaid eligibility guidelines violated the Social Security Act to the extent that they used income or resource methodologies that were more restrictive than those under the SSI program.<sup>246</sup> Virginia, a section 209(b) state, established Medicaid eligibility guidelines that were more restrictive than those under SSI.<sup>247</sup> For example, under SSI, property that includes or is contiguous to the actual home site is excluded from the resource computation.<sup>248</sup> Under the Virginia resource methodology, however, only an applicant's home and the lot on which it stands (or one acre in rural areas) plus no more than \$5,000 worth of additional property are excluded.<sup>249</sup> The plaintiffs were all low-income rural residents who owned property contiguous to their homes. The value of the contiguous property rendered

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240. 862 F.2d 1079 (4th Cir. 1988), *cert. denied*, 109 S. Ct. 2434 (1989).

241. *Id.* at 1082.

242. *Id.*

243. *Id.* at 1084.

244. *Id.* at 1085.

245. 914 F.2d 593 (4th Cir. 1990).

246. *Id.* at 595.

247. *Id.*

248. 42 U.S.C. § 1382b(a)(1) (1988).

249. *Mowbray*, 914 F.2d at 595 (citing VA. CODE ANN. § 32.1-325(A)(3)).

each of the plaintiffs ineligible for Medicaid benefits under Virginia's guidelines, but would not have resulted in ineligibility under the SSI guidelines.<sup>250</sup>

The district court invalidated the Virginia rule on the grounds that section 303(e) of the MCCA amended section 209(b) to prevent states from utilizing standards more restrictive than the SSI standards and that were not in effect as of January 1, 1972.<sup>251</sup> States still have the right, however, to utilize more restrictive standards as long as they were in place before January 1, 1972.<sup>252</sup>

On appeal, the Fourth Circuit reversed the district court, and held that section 303(e) did not partially repeal section 209(b).<sup>253</sup> Thus, Virginia's more restrictive Medicaid eligibility criteria did not violate section 303(e).<sup>254</sup> The court based its holding on its belief that Congress had not spoken clearly enough to infer repeal of a prior statute allowing states to utilize more restrictive eligibility criteria.<sup>255</sup> Additionally, the court gave great deference to the Secretary's interpretation of section 303(e)'s statement that state methodologies "'may be less restrictive' than SSI methodologies"<sup>256</sup> and was designed to permit states to use more liberal methodologies.<sup>257</sup> The court also stated that the phrase "'shall be no more restrictive'" was simply a condition on that liberality.<sup>258</sup>

## II. ESTATE PLANNING TECHNIQUES AND CONSIDERATIONS

### A. *Trusts*

*1. General Provisions.*—For persons who are not categorically eligible for Medicaid, the Medicaid eligibility criteria include a consideration of the applicant's assets and income. Thus, Medicaid eligibility for these persons is premised upon their inability to meet the cost of supporting themselves with funds from other sources. Special considerations arise when a Medicaid applicant is also the named beneficiary of a trust. The primary problem for courts considering this issue is deciding how to

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250. *Id.* at 594.

251. Section 303(e) of the MCCA states: "The methodology to be employed in determining income and resource eligibility for individuals under subsection . . . (f) [the 209(b) option] . . . may be less restrictive, and may be no more restrictive than that under SSI." 42 U.S.C. § 1396(r)(2)(A)(i) (1988).

252. *Mowbray v. Kozlowski*, 914 F.2d 593, 596 (4th Cir. 1990).

253. *Id.* at 594.

254. *Id.*

255. *Id.*

256. *Id.* at 600.

257. *Id.* at 601.

258. *Id.*

balance a settlor's intent to prevent the invasion and ultimate depletion of trust funds against the interests of taxpayers bearing Medicaid's financial burden when the applicant could be self-supporting if the trust corpus is invaded.

As mentioned above, only nonexempt assets are counted toward an applicant's asset limit.<sup>259</sup> In general, funds placed in a trust to which a Medicaid applicant is a named beneficiary are not exempt if the trust is revocable or is designed to pay the applicant's medical needs or general expenses.<sup>260</sup> Similarly, any part of the trust's income or principal that an applicant has a right to obtain is counted toward the applicant's asset limit.<sup>261</sup>

Before 1986, estate planners were able to use a discretionary trust to isolate the trust corpus from the beneficiary and to maintain the beneficiary's Medicaid eligibility.<sup>262</sup> In 1986, however, Congress amended the Medicaid statute to prevent the use of discretionary trusts to shelter assets for Medicaid eligibility purposes.<sup>263</sup> The 1986 amendment provides that the amounts included in a "Medicaid qualifying trust" shall be considered available to the maximum extent possible, assuming that the trustee exercises the greatest possible discretion in the beneficiary's favor.<sup>264</sup> The amendment defines a "Medicaid qualifying trust" as

a trust, or similar legal device, established (other than by will) by an individual (or an individual's spouse) under which the individual may be the beneficiary of all or part of the payments from the trust and the distribution of such payments is determined by one or more trustees who are permitted to exercise any discretion with respect to the distribution to the individual.<sup>265</sup>

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259. See *supra* notes 167-93 and accompanying text.

260. See *infra* notes 266-88 and accompanying text. The grantor's ability to revoke the trust could invite creditors to attack the trust for reimbursement.

261. The MCCA's attribution rules for trust income provide that any income to be paid to a Medicaid recipient will be considered to be income available to the recipient for Medicaid eligibility purposes. Similarly, if the trust provides for income to be paid to both an institutionalized Medicaid recipient and the recipient's at-home spouse, any income made payable to both spouses will be considered available to each spouse in proportion to the spouse's interest. 42 U.S.C. § 1396r-5(b)(2) (1988). These attribution rules for trust property, however, may be varied by specific trust language.

262. Under a truly discretionary trust, the trustee may withhold the entire trust income and principal from the beneficiary, and the beneficiary, as well as the beneficiary's creditors and assignees, cannot compel the trustee to pay over any part of the trust funds. *Lineback v. Stout*, 79 N.C. App. 292, 296, 339 S.E.2d 103, 106 (1986). Courts have almost uniformly held that a truly discretionary trust is not "available" to the applicant for Medicaid eligibility purposes. See *infra* notes 267-88 and accompanying text.

263. See 42 U.S.C. § 1396a(k)(1) (1988).

264. *Id.*

265. *Id.* § 1396a(k)(2).

2. *Testamentary Trusts.*—Although the 1986 amendment was clearly intended to proscribe the use of discretionary trusts to shelter assets for Medicaid eligibility purposes, the amendment contains several loopholes that permit estate planners to set up discretionary trusts to shelter excess assets. For example, the amendment clearly excludes testamentary trusts.<sup>266</sup> Thus, a discretionary trust may be created under a will for a surviving spouse, and the trust's funds will not be considered to be resources available to the beneficiary for Medicaid eligibility purposes.

In *In re Estate of Tashjian*,<sup>267</sup> the decedent executed a will designating his wife as the beneficiary and instructing the trustee, within his discretion, to expend such amount of the trust principal as the trustee determined was necessary for the beneficiary's support and maintenance. Under the terms of the trust, the beneficiary was to be paid the trust income on a regular basis. Upon determining that the trust income would not cover the beneficiary's living expenses, the trustee petitioned the trial court for a determination of whether the trust principal should be invaded for the beneficiary's benefit.

The trial court ruled that the testator had directed the trustee to pay only the trust income and that the trustee could not invade the trust corpus for the beneficiary's benefit. On appeal, the Pennsylvania Superior Court affirmed, opining that although ambiguous trust provisions should be viewed as authorizing the invasion of trust principal even when the beneficiary has access to other income sources, courts must effectuate the testator's intent.<sup>268</sup> The court focused on the specific trust language granting the trustee sole discretion over the disbursement of the trust funds, and determined that the testator gave the trustee considerable discretion to withhold the trust's funds from a beneficiary with independent resources.<sup>269</sup> Similarly, the court noted that the circumstances surrounding the trust's execution indicated that the testator intended the trust corpus to serve as a reserve for his wife in the event that her income from other sources proved inadequate to meet her needs.<sup>270</sup>

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266. Under the 1986 amendment, a "Medicaid qualifying trust" is defined in part as "a trust, or similar legal device, established (other than by will) . . . ." *Id.* (emphasis added).

267. 375 Pa. Super. 221, 544 A.2d 67 (1988).

268. *Id.* at 226, 544 A.2d at 70.

269. *Id.* at 228-29, 544 A.2d at 71. The court also cited *Lang v. Department of Public Welfare*, 515 Pa. 428, 528 A.2d 1335 (1987), for the proposition that the fact that a will establishes a trust for the beneficiary's support does not create an irrebuttable presumption that all of the beneficiary's living expenses must be funded from the trust.

270. *Tashjian*, 375 Pa. Super. at 229, 544 A.2d at 71-72. Likewise, in *Tidrow v. Director, Missouri State Division of Family Services*, 688 S.W.2d 9 (Mo. App. 1985), one

In contrast, in *Tutino by Portela v. Perales*,<sup>271</sup> the court held that the State Commissioner of Social Services may require a person who is both the settlor and the beneficiary of an inter vivos trust to execute an assignment of rights to seek an allowance from the trust principal as a prerequisite to granting medical assistance.<sup>272</sup> In *Tutino*, a husband and wife established an inter vivos trust and directed the trustee to "hold, invest, and reinvest the Trust Estate, collect the income therefrom and pay and apply all of the net income to the settlors" for their foreseeable costs of living.<sup>273</sup> Approximately six months after the trust was created, the husband died and the wife was placed in a nursing home. The trustee applied for medical assistance on behalf of the wife, and the application was denied.

In confirming the commissioner's denial of benefits, the court noted that other cases involving *testamentary* trusts that were construed as precluding an allowance from the principal were not applicable.<sup>274</sup> The court reasoned that the trust was a potentially available resource because the settlor was the same person "whose medical needs prompted the application for assistance."<sup>275</sup>

3. *Nonspousal Trusts*.—The 1986 amendment also applies only to discretionary trusts that run between an individual and that individual's spouse.<sup>276</sup> Hence, the amendment does not prohibit discretionary trusts established by a child for a parent, a parent for a child, or for any persons not in a spousal relationship.

In *Snyder v. Department of Public Welfare*,<sup>277</sup> a nursing home resident's medical assistance benefits were terminated because assets of a trust established by the resident's mother were allegedly available to the resident. The court, following the general rule that the settlor's intent determines whether trust assets are an available resource to the bene-

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of the reasons the court did not find the trust corpus to be a resource available to the beneficiary was because the settlor intended the trust funds to supplement rather than supplant the benefits to which the beneficiary would otherwise be entitled. As evidence of the settlor's intent, the court noted that the trust was established to support the beneficiary for the beneficiary's life and the trust corpus was not intended to be depleted in a few years.

271. 153 A.D.2d 181, 550 N.Y.S.2d 21, *appeal denied*, 76 N.Y.2d 708, 559 N.E.2d 678, 559 N.Y.S.2d 984 (1990).

272. *Id.* at 186, 550 N.Y.S.2d at 24.

273. *Id.* at 182-83, 550 N.Y.S.2d at 22.

274. *Id.* at 187, 550 N.Y.S.2d at 24.

275. *Id.* at 187, 550 N.Y.S.2d at 25. One can argue, however, that the 1986 amendment would not prohibit an irrevocable inter vivos trust in which a person deposits a sum of money in the name of another as trustee for the benefit of a third party beneficiary.

276. 42 U.S.C. § 1396a(k)(2) (1988).

277. 124 Pa. Commw. 511, 556 A.2d 31 (1989).

ficiary, set forth four factors which, if present, indicate that a settlor did not intend for the trust assets to support a beneficiary.<sup>278</sup>

First, the court noted that the trust was established to benefit all of the settlor's children, not just the child who became institutionalized.<sup>279</sup> Second, the court noted that the trust language stating that the trustee was directed to "use as much of the net income as may be necessary . . . for the support, maintenance, and care" of the beneficiaries gave the trustee great discretion in disbursing the trust funds.<sup>280</sup> Moreover, the trust instrument clearly directed the trustee to use the trust's net income for the support of the institutionalized child, and did not give the trustee discretion to distribute or accumulate income that was not necessary for the institutionalized child's care.<sup>281</sup> Finally, the court attached special significance to the fact that the settlor accepted the state's help in paying for the institutionalized child's health care costs.<sup>282</sup>

In *Hoelzer v. Blum*,<sup>283</sup> a testamentary trust established by a parent for a child contained a provision authorizing the trustee to distribute the trust's principal only if the beneficiary died or an "emergency" arose. The state agency denied the beneficiary's application for medical assistance on the authority of a state statute empowering courts to invade the corpus of a trust established for the maintenance, support, or education of an income beneficiary absent authority in the trust instrument.

On appeal, the court reversed the agency's denial of benefits.<sup>284</sup> Not only did the statute not apply,<sup>285</sup> the court opined, but the beneficiary's need for medical assistance was not an "emergency" mandating invasion of the trust corpus.<sup>286</sup> The court noted that the beneficiary had been disabled since birth, had been cared for in the family home for forty-four years before her father's death, and the settlor had made a specific provision in the trust for the beneficiary to be placed in a home with

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278. *Id.* at 515, 556 A.2d at 33-34.

279. *Id.* at 515, 556 A.2d at 34. In *Stoudt v. Department of Public Welfare*, 76 Pa. Commw. 576, 464 A.2d 665 (1983), the court held that the funds in a trust established by a parent for a child were resources available to the child because the child was the sole beneficiary of the trust.

280. *Snyder*, 124 Pa. Commw. at 516, 556 A.2d at 32-33. Similarly, in *Chenot v. Bordeleau*, 561 A.2d 891 (R.I. 1989), the court held that because the trustee was not required to provide any specific support to the child, funds in a trust established by a parent for a child were available to the child in determining the child's eligibility for medical assistance benefits.

281. *Snyder*, 124 Pa. Commw. at 517, 556 A.2d at 34.

282. *Id.* at 516, 556 A.2d at 34.

283. 93 A.D.2d 605, 462 N.Y.S.2d 684 (1983).

284. *Id.* at 609, 462 N.Y.S.2d at 690.

285. *Id.* at 611, 462 N.Y.S.2d at 688.

286. *Id.* at 614, 462 N.Y.S.2d at 689-90.

the trust *income* to go to the home.<sup>287</sup> From these facts, the court reasoned that the settlor clearly did not intend nursing home care to be an "emergency" requiring the trustee to invade the trust corpus.<sup>288</sup>

4. *Estate Planning Considerations.*—A discretionary trust can be an extremely useful and practical device for isolating otherwise nonexempt assets in order to maintain the beneficiary's eligibility for Medicaid. Discretionary trusts, however, must be structured in accordance with certain guidelines in order to ensure protection of the trust corpus from creditors and to ensure the elimination of nonexempt assets from the computation of a beneficiary's available assets. For example, the trust terms should specifically state that the trust's purpose is to provide assistance to the beneficiary in addition to any public assistance benefits including but not limited to Medicaid. Although courts will examine the circumstances surrounding the trust's creation in order to determine the settlor's intent, they may find that the settlor intended the trust to supplement other available benefits.<sup>289</sup> Specific trust language can make the settlor's intent clear and eliminate the possibility of an adverse decision.

Similarly, as was the situation in the cases in which the court ruled that the trust corpus was unavailable to the beneficiary for Medicaid eligibility purposes, the trust provisions should clearly prohibit the beneficiary from demanding either the trust corpus or income. The trustee should be given full discretion over the distribution of the trust income and the corpus.

As previously mentioned, any trust income that the trustee pays to the beneficiary will be considered income available for Medicaid eligibility purposes.<sup>290</sup> Thus, the trust provisions should limit the amount of trust income that the trustee disburses to the beneficiary to an amount less than the applicable income eligibility limit.

Finally, the trust provisions should avoid language that places limitations on the trustee's discretionary powers. Mandatory language *must* be avoided. The trustee must be granted complete and uncontrolled discretion to allocate the trust funds when the trustee deems allocations necessary. When a trustee has complete discretion, a beneficiary can only compel the trustee to distribute trust funds if the beneficiary can

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287. *Id.* at 613, 462 N.Y.S.2d at 689-90.

288. *Id.* at 614, 462 N.Y.S.2d at 690.

289. See, e.g., *Tidrow v. Director, Missouri State Div. of Family Servs.*, 688 S.W.2d 9, 12 (Mo. App. 1985) (father intended trust to supplement benefits); *In re Estate of Tashjian*, 375 Pa. Super 221, 229, 554 A.2d 67, 71 (1988) (testimony indicated that testator intended that the corpus serve as a reserve for widow).

290. See *supra* note 261 and accompanying text.

show that the trustee is abusing his or her discretion or acting arbitrarily or dishonestly.<sup>291</sup>

### *B. Protecting the Estate from Reimbursement Claims*

1. *Federal Statutory Provisions.*—Medicaid eligibility does not ensure that the recipient has successfully preserved any remaining assets for inheritance. The Medicaid statute contains provisions authorizing state agencies to recover for medical assistance benefits paid on behalf of an individual under the state Medicaid plan.<sup>292</sup> Estate planners for Medicaid applicants should take these provisions into consideration in order to preserve the largest possible amount of the estate for inheritance.

The Medicaid statute contains two provisions authorizing the recovery of Medicaid benefits paid to recipients. The first provision, commonly known as the third-party recovery provision, requires state agencies administering Medicaid programs to "take all reasonable measures to ascertain the legal liability of third parties . . . to pay for care and services" available under Medicaid.<sup>293</sup> When potential liability for payment is identified, the statute obligates the state to pursue the third party "where the amount of reimbursement the State can reasonably expect to recover exceeds the costs of such recovery."<sup>294</sup> One court recently opined that the overriding purpose of the third-party liability provision was to benefit both the federal and state governments.<sup>295</sup> Thus, the court held that a state may not seek third-party liability from the federal government.<sup>296</sup>

Another provision authorizing the recovery of Medicaid benefits states:

No adjustment or recovery of any medical assistance correctly paid on behalf of an individual under the State plan may be made except —

(A) in the case of an individual described in subsection (a)(1)(B) of this section, from his estate or upon sale of the property subject to a lien imposed on account of medical assistance paid on behalf of such individual, and

(B) in the case of any other individual who was 65 years of age or older when he received such assistance, from his estate.<sup>297</sup>

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291. See, e.g., *Town of Randolph v. Roberts*, 346 Mass. 578, 195 N.E.2d 72 (1964).

292. See 42 U.S.C. §§ 1396(a)(25), 1396p (1988).

293. *Id.* § 1396a(a)(25)(A).

294. *Id.* § 1396a(a)(25)(B).

295. *New York State Dep't of Social Servs. v. Bowen*, 684 F. Supp. 775, 779 (E.D.N.Y. 1988).

296. *Id.*

297. 42 U.S.C. § 1396p(b)(1)(A), (B) (1988).

Recent case law has developed concerning the definition of "estate" and whether a state agency's recovery is limited to the Medicaid recipient's estate.

In *Citizens Action League v. Kizer*,<sup>298</sup> plaintiffs succeeded to property that they had formerly held in joint tenancy with a Medicaid recipient. A California statute authorized the state agency to "claim against the estate of the decedent, or against any recipient of the property of the decedent by distribution or survival, an amount equal to the [Medi-Cal] payments received."<sup>299</sup> However, the statute only discussed recoupment from a recipient's "estate." The Ninth Circuit reversed the lower court's finding that the state agency was entitled to reimbursement,<sup>300</sup> and held that Congress's use of the word "estate" limited a state's recovery to property that descends to the recipient's heirs or to the beneficiaries of the recipient's will.<sup>301</sup> The court, in reaching its decision, noted that at common law, the term "estate" excluded interests in a decedent's property that were formerly held in joint tenancy.<sup>302</sup>

Perhaps even more important from an estate planning standpoint is that the court also noted that many of the plaintiffs "became joint tenants with the now deceased recipients under arrangements that Congress wanted to encourage."<sup>303</sup> Namely, Congress wanted to encourage at-home care to be provided for a Medicaid recipient in exchange for the caregiver having "a place to live, both during the provision of care and after the recipient's death."<sup>304</sup>

In *In re Imburgia*,<sup>305</sup> a state agency filed a reimbursement claim against the estate of a Medicaid recipient's surviving spouse. The estate's executors refused to reimburse the state agency, and argued that because the Medicaid statute only provides for reimbursement from a recipient's estate, recovery against a surviving spouse's estate is prohibited.

The court disagreed, and held that the Medicaid statute authorizes state agencies to claim reimbursement from the estates of responsible

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298. 887 F.2d 1003 (9th Cir. 1989), *cert. denied sub nom.* Department of Health Servs. of Cal. v. Citizens Action League, 110 S. Ct. 1524 (1990).

299. *Id.* at 1005 (quoting CAL. WELF. & INST. CODE § 14009.5 (West Supp. 1989) (emphasis in original)).

300. *Id.* at 1008.

301. *Id.* at 1006.

302. *Id.* The term "estate" probably also excludes property held in tenancy by the entirety. In *In re Savage's Estate*, 650 S.W.2d 346 (Mo. App. 1983), the court held that property held in tenancy by the entirety is not subject to a lien or attachment for the debt of one tenant, and the voluntary conveyance of property to the other tenant is not fraudulent to creditors of the grantor.

303. *Citizens Action League v. Kizer*, 887 F.2d 1003, 1008 (4th Cir. 1989).

304. *Id.*

305. 127 Misc. 2d 756, 487 N.Y.S.2d 263 (1984), *aff'd*, 103 A.D.2d 658, 515 N.Y.S.2d 590 (1987).

relatives of Medicaid beneficiaries.<sup>306</sup> The court, in reaching its decision, noted that the policy that precludes a Medicaid recipient's spouse from becoming impoverished during the spouse's lifetime does not apply after the spouse's death.<sup>307</sup> Additionally, the court noted that the spouse's estate contained income beyond the eligibility limits.<sup>308</sup>

2. *State Laws.*—States may also claim reimbursement for Medicaid payments based on authority outside the Medicaid statute's scope. For example, in Maine, illegally obtained Medicaid benefits may be recovered from a decedent's estate.<sup>309</sup> Similarly, a participating state may assert that a transfer of assets that did not interfere with an applicant's Medicaid eligibility should be set aside as a fraudulent conveyance under applicable provisions of the state's debtor-creditor laws.

In *Crabb v. Estate of Mager*,<sup>310</sup> the court held that a county department of social services may use the applicable provisions of the state's debtor-creditor law to set aside an allegedly fraudulent conveyance of a homestead in order to bring the homestead back into a former medical assistance recipient's estate.<sup>311</sup> Although ownership of homestead property does not affect Medicaid eligibility, the presence of homestead property in the estate of a former benefit recipient may be used to reimburse the state agency.<sup>312</sup>

In *Crabb*, an institutionalized medical assistance recipient transferred her home to her son without compensation, thereby removing the home from the recipient's estate. A few months before the transfer, the recipient's son executed an instrument acknowledging that upon the recipient's death, the department could file a claim for reimbursement. The court opined that the sole reason for the recipient's transfer of her home was to prevent the department from receiving reimbursement from the recipient's estate<sup>313</sup> and, citing prior case law, ruled that a fraudulent conveyance of an interest in real estate may be set aside under the state's debtor-creditor laws.<sup>314</sup>

3. *Trusts.*—When a Medicaid recipient who is also a trust beneficiary dies, a state Medicaid agency may claim reimbursement from the trust for Medicaid payments made on the beneficiary's behalf. Whether an agency succeeds in obtaining reimbursement from a trust depends

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306. *Id.* at 758, 487 N.Y.S.2d at 265.

307. *Id.* at 760, 487 N.Y.S.2d at 266.

308. *Id.* at 759, 487 N.Y.S.2d at 266.

309. ME. REV. STAT. ANN. tit. 22, § 14(2-G) (1990).

310. 66 A.D.2d 20, 412 N.Y.S.2d 508 (1979).

311. *Id.* at 25, 412 N.Y.S.2d at 511.

312. *Id.* at 25, 412 N.Y.S.2d at 510.

313. *Id.* at 25, 412 N.Y.S.2d at 509.

314. *Id.* at 25, 412 N.Y.S.2d at 511.

largely upon the type of trust from which reimbursement is sought, the circumstances surrounding the creation of the trust, and the settlor's intent. An additional concern is whether a participating state has enacted a statute obligating a settlor to reimburse a state Medicaid agency for benefits paid on behalf of the trust beneficiary.

In *Department of Mental Health and Developmental Disabilities v. Phillips*,<sup>315</sup> a mother established an inter vivos trust for the benefit of her institutionalized child. The trust contained a spendthrift clause designed to "protect the trust income and corpus from claims of creditors or legal process."<sup>316</sup> The trust also named the beneficiary's two brothers as remaindermen. Due to the spendthrift provision, the trustee did not disburse any of the trust funds to compensate the defendant for medical services provided to the beneficiary. Consequently, the defendant petitioned the court for reimbursement from the trust.

The court, in holding that the defendant was not entitled to reimbursement, noted that although the trust provisions were unclear as to whether the settlor intended to establish a fund to provide the beneficiary with services to supplement state care, the circumstances surrounding the trust's creation clearly established that the settlor's intent was to provide services that the defendant was unwilling or unable to provide.<sup>317</sup> The court also noted that the settlor was not under a statutory obligation to reimburse the defendant for medical services provided to the beneficiary.<sup>318</sup>

Another important aspect of *Phillips* is that the court clearly stated that in Illinois, trusts containing spendthrift or discretionary provisions are not automatically protected from reimbursement claims.<sup>319</sup> The court opined that the trustee's absolute discretion is "not an arbitrary one which would permit the trustee to provide no support whatsoever for the beneficiary, thereby throwing the beneficiary on the charity of others or the state."<sup>320</sup> Thus, the court reasoned that a spendthrift trust may be considered to be a part of the beneficiary's estate.<sup>321</sup> As a result, the settlor's intent and the factors surrounding the trust's creation become even more significant in determining whether a particular trust is subject to reimbursement.<sup>322</sup>

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315. 114 Ill. 2d 85, 500 N.E.2d 29 (1986).

316. *Id.* at 88-89, 500 N.E.2d at 31.

317. *Id.* at 94, 500 N.E.2d at 33.

318. *Id.*

319. *Id.* at 90, 500 N.E.2d at 31.

320. *Id.* at 90, 500 N.E.2d at 32 (citing *Estate of Lackman v. Department of Mental Hygiene*, 156 Cal. App. 2d 674, 320 P.2d 186 (1958)).

321. *Id.* at 90, 500 N.E.2d at 31.

322. *Id.* at 91, 500 N.E.2d at 33.

Another Illinois case decided two years after *Phillips* also involved reimbursement from a discretionary trust. In *Button v. Elmhurst National Bank*,<sup>323</sup> the Illinois Court of Appeals determined that the circumstances surrounding the trust's execution did not indicate that the settlor intended the trust to provide benefits that the state agency did not provide.<sup>324</sup> Thus, the court held that the defendant was permitted to obtain reimbursement from the trust.<sup>325</sup>

The court also noted that at the time of the trust's execution, the settlor was under a legal obligation to reimburse the defendant for medical services.<sup>326</sup> The court also cited *Phillips* favorably for the notion that discretionary trusts may be considered to be part of a beneficiary's estate, and noted a long-standing policy permitting state agencies to seek reimbursement for their costs from recipients who can afford to pay.<sup>327</sup> In *Button*, the court also observed that substantial assets would remain in the trust after reimbursement.<sup>328</sup>

Alternatively, in *Miller v. Department of Mental Health*,<sup>329</sup> the court ruled that the defendant could not receive reimbursement of funds if on remand the probate court found that the trust was discretionary.<sup>330</sup> The court held that because the beneficiary of a discretionary trust does not have an ascertainable interest in the assets of the trust, the assets cannot be subject to reimbursement.<sup>331</sup>

In summary, estate planners can follow several general guidelines of trust construction to protect the trust income and corpus against reimbursement. For instance, the trust terms should clearly specify that the trust income may be used only to *supplement* public assistance benefits that the beneficiary may receive. The trust terms should also specify that the trust income may be used as a supplement to other sources until the beneficiary's death, whereupon the remainder interest passes to the remaindermen. Courts are more likely to protect the trust corpus if it will pass to a person holding a remainder interest. Similarly, creditors are likely to be less successful in receiving reimbursement from the trust corpus or other undistributed income if the remainder interest is already vested in persons or entities other than the beneficiary's estate.

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323. 169 Ill. App. 3d 28, 522 N.E.2d 1368, *appeal denied*, 112 Ill. 2d 570, 530 N.E.2d 240 (1988).

324. *Id.* at 42, 522 N.E.2d at 1377.

325. *Id.* at 40, 522 N.E.2d at 1376.

326. *Id.* at 43, 522 N.E.2d at 1378.

327. *Id.* at 39, 522 N.E.2d at 1375.

328. *Id.* at 44, 522 N.E.2d at 1379.

329. 432 Mich. 426, 442 N.W.2d 617 (1989).

330. *Id.* at 437, 442 N.W.2d at 617.

331. *Id.* at 427, 442 N.W.2d at 617.

4. *Miscellaneous.*—The reimbursement issue also has surfaced in other contexts. For example, in *In re Porter*,<sup>332</sup> the Arkansas Supreme Court upheld a probate court's ruling that the principal of a certificate of deposit in a Medicaid beneficiary's estate was inaccessible to the guardian for reimbursement for Medicaid benefits.<sup>333</sup> The Arkansas Supreme Court ruled that exclusive jurisdiction rested with the probate court.<sup>334</sup>

Similarly, in *Beltrami County v. Goodman*,<sup>335</sup> the court ruled that funds received from a wrongful death action are available to reimburse a state agency for payment of medical assistance.<sup>336</sup> The court, in reaching its decision, reasoned that the legislature intended to place the burden on the tortfeasor rather than the taxpayer.<sup>337</sup>

### III. CONCLUSION

Americans are living longer, and an increasing number of the elderly are likely to need extended medical care in their old age. This increased need for costly long-term health care complicates estate planning. Consequently, estate maximization includes structuring the estate so that Medicaid eligibility may be established and maintained.

The federal Medicaid statute is extremely complex and contains many traps for the uninitiated planner. Estate planners must recognize and address several problem areas when formulating plans for elderly clients who are contemplating a potential need for long-term health care. First, planning must be structured to meet the Medicaid eligibility tests for an individual client in the applicable jurisdiction. Of primary concern is the transfer-of-assets and transfer-of-income regulations. Second, estate planning must be organized so that a Medicaid beneficiary's estate is protected to the greatest extent possible from creditors' claims after the recipient's death. To achieve this result, estate planners should encourage at-home care givers to hold property in joint tenancy with Medicaid benefit recipients.

Although discretionary trusts can be an effective estate planning tool for handling long-term health care needs, planners must recognize the requirements for maintaining Medicaid eligibility for their clients who are also trust beneficiaries. Similarly, estate planners should learn to

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332. 765 S.W.2d 944 (1989).

333. *Id.* at 945-46.

334. *Id.* at 948.

335. 427 N.W.2d 662 (Minn. 1988).

336. *Id.* at 664.

337. *Id.* See also *In re K.S.*, 427 N.W.2d 653 (Minn. 1988).

construct trusts in a manner that effectively protects the trust corpus against reimbursement claims from medical service providers.

In general, practitioners should counsel their younger clients, especially those who have an increased potential for long-term health care, to develop a lifetime strategy of financial management. Long-term health care in old age can be financially devastating. Yet, disciplined stewardship of financial resources practiced over the course of a lifetime, coupled with an effective estate plan, can significantly lessen the financial burden of long-term health care.



# Agricultural Taxation - Selected Issues

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## I. ALTERNATIVE MINIMUM TAX - DEFERRED PAYMENT GRAIN SALES - TAX TRAP

### A. *Introduction*

Cash-basis taxpayers must recognize income from the sale of property in the taxable year in which they actually or constructively receive payment for the property.<sup>1</sup> Treasury Regulation § 1.451-2(a) provides that taxpayers must declare "constructive income" in the taxable year that the income was set aside or was made available for the taxpayer, even though the taxpayer did not actually possess the income, unless the taxpayer's ability to recover the money was substantially limited.<sup>2</sup> The Internal Revenue Service (I.R.S.) has approved, in some circumstances, a farmer's practice of deferring recognition of income from sales of crops or livestock by entering into deferred payment contracts.<sup>3</sup> In addition, a farmer may be able to defer recognition of income for regular tax purposes, though not for purposes of alternative minimum taxes,<sup>4</sup> if the farmer enters into a

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1. I.R.C. § 451(a) (1988); Treas. Reg. § 1.451-1(a) (as amended in 1978).

2. Treas. Reg. § 1.451-2(a) (as amended in 1979). The regulation states in part: Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

*Id.*

3. See, e.g., Rev. Rul. 58-162, 1958-1 C.B. 234. A deferred payment contract is "an agreement, usually in writing, between the farmer and the purchaser or processor of his crops to postpone payment from one taxable year into a later year." Fishman, *Revised Installment Provisions Breathe New Life into Farmers' Deferred-Payment Contracts*, 54 J. TAX'N 94, 94 (1981).

4. I.R.C. § 56(a)(6) (1988).

qualified installment sale.<sup>5</sup> The following two sections describe these practices and potential pitfalls.

### *B. Deferred-Payment Contracts*

If a cash-basis farmer or rancher enters into a written deferred-payment contract with the purchaser of crops or livestock that calls for payment at a certain time in the subsequent year and is also not assignable or usable as collateral for a loan,<sup>6</sup> the farmer may report the income in the subsequent year.<sup>7</sup> This deferred-payment contract delays the constructive receipt of the income until the year in which the taxpayer receives payment for the property.<sup>8</sup>

The contract must be a bona fide arm's length agreement and also must be entered into before the crop is delivered to the purchaser.<sup>9</sup> In Revenue Ruling 58-162, the farmer entered into deferred-payment contracts with a commercial grain elevator that provided the farmer would "receive payment for this grain on January -, 19 \_\_\_\_."<sup>10</sup> The I.R.S. ruled that because the farmer's contract was an arm's length agreement and did not entitle the farmer to payment until a fixed date in the subsequent year, the contract did not constitute constructive income under Treasury Regulation § 1.451-2(a).<sup>11</sup> A written contract complying with the requirement of Revenue Ruling 58-162 delays constructive receipt for both regular tax and alternative minimum tax purposes.<sup>12</sup>

If the purchaser is the farmer's agent, the agent's receipt of income for the sale of the property will be equivalent to receipt by the farmer-principal.<sup>13</sup> For instance, in Revenue Ruling 79-379 the farmer sold cattle to a licensed dealer under a deferred-payment contract.<sup>14</sup> The contract provided that the dealer would pay the farmer the price equal to the amount the dealer received for resale at the auction.<sup>15</sup> The resale was conducted by another dealer, an affiliate of the first dealer, who deducted

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5. See, e.g., *Applegate v. Commissioner*, 94 T.C. 696 (1990); see also I.R.C. § 453(a), (l)(2)(a) (1988).

6. I.R.C. § 453A(a)(2), (d) (1988).

7. *Id.* § 453(a), (c).

8. *Id.*

9. See *Reed v. Commissioner*, 723 F.2d 138, 143 (1st Cir. 1983); *Schniers v. Commissioner*, 69 T.C. 511, 516 n.2 (1977); Rev. Rul. 58-162, 1958-1 C.B. 234, 235.

10. Rev. Rul. 58-162, 1958-1 C.B. 234.

11. *Id.*; see also Rev. Rul. 73-210, 1973-1 C.B. 211 (application of doctrine of constructive receipt to deferred payment contracts with farmer cooperatives).

12. Rev. Rul. 58-162, 1958-1 C.B. 234.

13. Rev. Rul. 79-379, 1797-2 C.B. 204.

14. *Id.*

15. *Id.*

from the amount to be paid to the farmer the auction price of fees, expenses, and charges, and who bore the risk of loss while the cattle were at the stockyards awaiting auction.<sup>16</sup> The I.R.S. ruled that the dealer acted as the farmer's agent because the initial purchaser of the farmer's cattle gained nothing from the transaction except use of the money until it was paid to the farmer, bore no risk of loss, and was statutorily barred from sharing in the profits from the sale with its affiliated dealer.<sup>17</sup> The I.R.S. concluded that the dealer "acted as the agent of the taxpayer for the purpose of holding the proceeds of the auction sale for the [farmer] in order to defer receipt of the proceeds . . . ,"<sup>18</sup> and thus, the dealer's receipt of the proceeds was equivalent to the farmer's receipt, barring deferment of the income to the farmer until the year the dealer paid the farmer.<sup>19</sup>

If the farmer's contract is assignable or transferable, however, the contract may have a cash equivalent taxable to the farmer in the year of the sale rather than in the year the income was actually received.<sup>20</sup> Likewise, if the farmer executes a price-later contract (P.L.C.) for the sale of crop shares, the special privilege granted to sharecrop landlords of deferring recognition of rental income<sup>21</sup> may not apply because the P.L.C. may constitute a sale.<sup>22</sup>

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16. *Id.*

17. *Id.*

18. *Id.*

19. *Id. But cf.* Crimmins v. United States, 655 F.2d 135 (8th Cir. 1981) (deferred-payment contracts entered into by cattle ranchers with livestock marketing agency that unconditionally deferred the payment purchase price until the subsequent year was a bona fide agreement).

20. See Priv. Ltr. Rul. 80-01-001 (Sept. 4, 1979) (the absence of evidence that the contract was not assignable, the ability and willingness of the buyer to pay cash for the grain at the time of the sale, and the fact that the contract was acceptable as collateral for loans by lending institutions in the farmer's area all signified that the deferred-payment contract between farmer and buyer had a cash equivalent taxable in the year of sale and resulted in constructive income).

21. Treas. Reg. § 1.61-4(a) (as amended in 1972). This regulation provides an exception to the requirement of reporting gross income for crop shares. *Id.* The crop shares are includible in gross income in the year in which the crop shares "are reduced to money or the equivalent of money." *Id.* (emphasis added).

22. See Priv. Ltr. Rul. 87-26-007 (Mar. 23, 1987). In this ruling, the farmer collected rent from tenant farmers in the form of crop shares. *Id.* The farmer executed several P.L.C.s by exchanging warehouse receipts evidencing the farmer's ownership of stored grain with the commercial grain elevator for a contract that allowed the farmer to set the price during a 365-day pricing period. *Id.* The contracts did not bear interest nor contain any restrictions on transferability. *Id.* The I.R.S. ruled that the P.L.C.s constituted a sale of grain, even though the sale price was not included in the contract, and disallowed the farmer from coming within the special provisions of Treas. Reg. § 1.61-4. *Id.*

### C. *Installment Sales Contracts*

In the *Installment Sales Revision Act of 1980*,<sup>23</sup> Congress made several changes that allow cash-basis farmers to report on the installment basis. Thus, if the farmer contracts to sell property and be paid in the subsequent taxable year, and the constructive receipt doctrine does not allow the farmer to recognize the income in a subsequent year, the contract may still be a qualified installment sale.<sup>24</sup> However, for alternative minimum tax purposes, the installment sales contract will still be taxable in the year of sale.<sup>25</sup> This obligation is tempered by section 53's provision for a regular tax credit usable in a subsequent year.<sup>26</sup>

The importance of the installment sales provisions is illustrated in *Applegate v. Commissioner*.<sup>27</sup> In *Applegate*, the taxpayer delivered his grain to the elevator and entered into a P.L.C.<sup>28</sup> The I.R.S. contended that the taxpayer, being able to price the grain and receive the proceeds at any time, constructively received the income.<sup>29</sup> The taxpayer argued that the installment sale provisions applied and that the income was properly reported in the year it was priced.<sup>30</sup> The tax court determined that the contracts the taxpayer held were not "evidences of indebtedness payable on demand,"<sup>31</sup> were not readily marketable, and therefore the sale qualified as an installment sale.<sup>32</sup> The proceeds were reportable as income for regular tax purposes in the year the price was determined.<sup>33</sup>

Thus, the installment sales provisions of I.R.C. § 453 and the constructive receipt doctrine provide effective means of deferring recognition of income; however, the taxpayer must not have the ability to transfer or assign the contract, and the requirements for an installment sales contract under section 453 must be met.

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23. See generally I.R.C. § 453 (1988).

24. *Id.* § 453(a), (l)(2)(a). Section 453 allows income from an installment sale to be recognized under the installment method. *Id.* § 453(a). "Installment sale" is defined as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs" but does not include "dealer dispositions." *Id.* § 453(b)(1), (1)(2)(A). "Dealer dispositions" are expressly defined to exclude "[t]he disposition . . . of any property used or produced in the trade or business of farming . . ." *Id.* § 453(1)(2)(a).

25. I.R.C. § 56(a)(6) (1988).

26. *Id.* § 53 (the credit arises from a prior year minimum tax liability).

27. 94 T.C. 696 (1990).

28. *Id.* at 700-03.

29. *Id.* at 704.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

## II. DEPRECIATION UNDER SECTION 168

### A. Changes Affecting Agriculture Under Section 168

Under the accelerated cost recovery system provided for in section 168,<sup>34</sup> the depreciation deduction for trees or vines bearing fruit or nuts will be calculated using the straight-line method over a ten-year recovery period.<sup>35</sup> This method is applicable for property placed in service after December 31, 1988.<sup>36</sup> In addition, single-purpose agricultural structures are assigned a recovery period of ten years if placed in service after 1988.<sup>37</sup>

For property placed in service beginning in 1987, taxpayers may elect for regular tax purposes the depreciation rules that apply for alternative minimum tax purposes.<sup>38</sup> For taxable years beginning after March 31, 1988, property purchased and sold in the same tax year is not considered for purposes of calculating the 40% midquarter convention.<sup>39</sup> For property that is used in the trade or business of farming, the applicable depreciation method is the 150% declining-balance method, switching to the straight-line method at the appropriate time to maximize the depreciation allowance.<sup>40</sup> This is a limitation on the modified accelerated cost recovery system (MACRS) method available to other types of businesses. Depreciation Guides 1, 2, 3, and 4 are included in the appendix to assist the practitioner in sorting through the MACRS depreciation system maze.

### B. Expensing Election Under Section 179

The taxable income limitation provides that the amount eligible to be expensed is limited to the taxable income derived from the active conduct of all trades or businesses.<sup>41</sup> Several examples help illustrate this limitation. Suppose Jayne Brennan has two separate businesses. In business number one, she has a taxable loss of \$10,000. In 1990, she placed in service in that business a \$6,000 machine qualifying for section 179 expensing. In business number two, she has taxable income of \$19,000. Jayne can combine the taxable income from the two businesses, \$9,000 net income, and expense the \$6,000 machine purchased for use in business number one.

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34. I.R.C. § 168 (West Supp. 1990).

35. *Id.* § 168(b)(3)(E), (e)(3)(D)(ii).

36. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6029(d), 102 Stat. 3694 (1988).

37. I.R.C. § 168(e)(3)(D)(i) (West Supp. 1990).

38. *Id.* § 168(b)(2) (150% declining balance over the class life).

39. *Id.* § 168(d)(3)(B)(ii).

40. *Id.* § 168(b)(2)(B).

41. *Id.* § 179(b)(3)(A) (1988); Prop. Treas. Reg. § 1.179-2, 56 Fed. Reg. 12,873 (1991).

Alternatively, suppose that Jayne Brennan has two separate businesses. In business number one, she has a taxable income of \$10,000. In 1990, she placed in service in that business a \$6,000 machine qualifying for section 179 expensing. In business number two, she has a \$9,000 taxable loss. Jayne must combine the taxable incomes from the two businesses. The combined amount is \$1,000 of taxable income which is the total amount she can deduct under section 179 for 1990.

### *C. What Is an "Active" Trade or Business Under Section 179?*

The 1986 Tax Reform Act inserted the word "active" as a further definition of trade or business for purposes of a section 179 deduction.<sup>42</sup> Proposed amendments to Treasury Regulation § 1.179 provide some guidance as to the meaning of the word "active."<sup>43</sup> Generally, the term "trade or business" is defined the same as in section 162.<sup>44</sup> In determining whether there is an active trade or business, a facts and circumstances test will be applied.<sup>45</sup> An important purpose of the "active" requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income from that business.<sup>46</sup> The proposed amendments provide that a taxpayer is actively involved in a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business.<sup>47</sup> The proposed amendments provide only one example to illustrate the interpretation of active participation.<sup>48</sup> The following ex-

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42. I.R.C. § 179(b)(3)(A).

43. *Id.*; Prop. Treas. Reg. § 1.179-2.

44. Prop. Treas. Reg. § 1.179-2(c)(5)(i).

45. *Id.* § 1.179-2(c)(5)(ii).

46. *Id.*

47. *Id.*

48. *Id.* § 1.179-2(c)(5)(iii).

(iii) Example. The provisions of paragraph (c)(5)(ii) of this section are illustrated by the following example.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing \$9,500 for use in the active conduct of the salon. There were no other purchases of section 179 property during 1991. A's net income from the salon, before any section 179 deduction, totaled \$8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any section 179 property during 1991. A's allocable share of partnership net income was \$6,000. Based on the facts and circumstances, A meaningfully participates in

cerpts from a memorandum to the I.R.S. central regional counsel provide some insight into the I.R.S.'s interpretation prior to the proposed amendments, and also appear to have been used as an interpretative document in drafting the proposed amendments.

The application of section 179(b)(3)(A) involves a two-step analysis. First, the taxpayer must have taxable income from "trade or business." "Trade or business" has the same meaning for purposes of section 179 that it has for purposes of section 162. Second, the taxpayer must be engaged in the "active conduct" of the trade or business. The crucial issue is what constitutes "active conduct" of a trade or business by the taxpayer for purposes of determining which income and loss are computed in the "aggregate amount of taxable income."

The "active conduct" phrases in section 179 were added by the Tax Reform act of 1986. Congress did not specify a test for "active conduct" of a trade or business. We believe, therefore, that the proper approach to determine whether a taxpayer's activities rise to the level of active conduct of a trade or business is to apply a facts and circumstances test which includes the factors enunciated in *Groetzinger v. Commissioner*, \_\_\_\_U.S.\_\_\_\_, 107 S.Ct. 980 (1987), *aff'g* 771 F.2d 269 (7th Cir. 1985), *aff'g* 82 T.C. 793 (1984) (taxpayer must be involved in the activity with CONTINUITY AND REGULARITY, and the primary purpose must be for INCOME OR PROFIT). Although there is nothing in the legislative history that expressly ties section 179 to section 469, for the sake of brevity we believe that the temporary regulations under section 469 suggest some additional factors which might be relevant in fashioning a facts and circumstances test under section 179. *See, e.g.*, Temp. Reg. § 1.469-5T(a). We emphasize, however, that the factors utilized in the temporary regulations under section 469 are nonexclusive, and other factors may be relevant.

Because there is no direct correlation between the material participation test under section 469 and any other participation test under another Code section, *see* Temp. Reg. § 1.469-5T(b)(2), it is conceivable that a taxpayer's income or loss from an unrelated trade or business would be includable in the "aggregate amount of taxable income" for purposes of section 179(b)(3)(A) even though

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the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under section 179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is \$8,000, the net income from the salon.

such income or loss would constitute income or loss from a passive activity for purposes of section 469. For example, assume a taxpayer has businesses *C* and *D*, with taxable incomes of \$5,000 each. The taxpayer is involved in the operations of both businesses with continuity and regularity, and he looks to both businesses as sources of income or profit. Under a facts and circumstances analysis it is concluded that the taxpayer is engaged in the active conduct of each. Business *C* is in the business of property rentals; its income is reported by the taxpayer on Schedule E. The taxpayer purchases section 179 property for use in business *D* (a Schedule C business) at a cost of \$10,000. Although for purposes of section 469 income and loss from rental activities are strictly "passive" regardless of the taxpayer's material participation in the activity, we believe that the \$5,000 income from business *C* should enter into the calculation under section 179(b)(3)(A) because the taxpayer meets the "active conduct" requirement of that section.

Likewise, it is possible that income from a trade or business would be "active" income for purposes of section 469, but would be disregarded in the section 179(b)(3)(A) computation because, it is concluded after an examination of the relevant [sic] facts and circumstances that the taxpayer is not sufficiently involved in an income-seeking activity to be considered engaged in the active conduct of a trade or business. For example, under the temporary regulations under section 469, payments made to a retired partner constitute "active" income for purposes of section 469. *See, e.g.*, Temp. Reg. § 1.469-2T(c)(4). A retired partner who no longer regularly, continuously and substantially participates in the firm's operations would not be considered as engaged in the "active conduct" of a trade or business for purposes of section 179. Take the example above, but assume that the taxpayer is retired from business *C*, a law firm, and receives \$5,000 from the firm in the form of taxable distributions under a pension, profit-sharing or other retirement plan. Under these facts, only the \$5,000 income from business *D* is includable in the section 179(b)(3)(A) calculation, and the income from business *C* is disregarded.

Utilizing such a facts and circumstances approach, we believe that Schedule C and Schedule F income will generally be includable in the computation under section 179(b)(3)(A); the taxpayer who is a sole proprietor or a farmer is generally active in the conduct of his business or farm. As discussed more fully in part B below, wage and salary income is includable in the computation. The taxpayer who reports rental income on Schedule E may or may not be engaged in the active conduct of a trade or business, depending upon whether he actively participates in the management

of the rental property. Income received through a pass-through entity such as a partnership or subchapter S corporation likewise may or may not be includable, depending upon the taxpayer's degree of participation in the trade or business of the partnership or subchapter S corporation . . . .<sup>49</sup>

An employee's wage income is income from an active trade or business. The proposed amendments to the regulations under section 179 indicate that an employee is engaged in a trade or business.<sup>50</sup> Therefore, the wage income qualifies as taxable income from a trade or business and could be combined, for example, with a net loss from a Schedule C or Schedule F business so that the aggregate taxable income is positive, permitting a section 179 deduction for an asset acquired in the Schedule C or Schedule F business.<sup>51</sup>

### III. NEW LIMITATIONS ON LIKE-KIND EXCHANGES BETWEEN RELATED PERSONS

Generally, when related persons<sup>52</sup> exchange like-kind property, no gain

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49. Memorandum from Director, Tax Litigation Division to Regional Counsel, Central Region (Sept. 14, 1988).

50. Proposed Amendments to Treas. Reg. § 1.179-2(c)(5)(iv).

51. *Id.*

52. I.R.C. § 1031(f)(3) (1988). This section provides that a "related person" is defined by section 267(b). Section 267(b) defines "related person[s]" as:

- (1) Members of a family, as defined in subsection [267] (c)(4);
- (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- (3) Two corporations which are members of the same controlled group (as defined in subsection [267] (f));
- (4) A grantor and a fiduciary of any trust;
- (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- (6) A fiduciary of a trust and a beneficiary of such trust;
- (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- (10) A corporation and a partnership if the same persons own—
  - (A) more than 50 percent in value of the outstanding stock of the

or loss is included as income.<sup>53</sup> Under Section 1031(f)(1)(C), however, if either person disposes of the property within two years after the date of the last transfer that was a part of the exchange, the exchange is disqualified from nonrecognition treatment.<sup>54</sup> If a disposition occurs within two years of the original disposition, the gain or loss must be recognized from the date of disposition of the property.<sup>55</sup> The tax event, however, occurs in the year of the disqualifying disposition, not the year of the original exchange.<sup>56</sup>

Several statutory exceptions to the new rules exist. The new rules generally do not apply to dispositions due to the death of either related person,<sup>57</sup> involuntary conversions,<sup>58</sup> or exchanges or dispositions for which the main purpose is not the avoidance of federal income tax.<sup>59</sup> The senate committee explanation states that the "non-tax avoidance exception generally will apply to: (i) transactions involving an exchange of undivided interests. . . ; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties."<sup>60</sup>

#### IV. NEW LIMITATIONS ON DEDUCTIONS FOR TERM INTERESTS IN PROPERTY HELD BY RELATED PERSONS

Section 167(r) closes a potentially abusive tax-planning loophole in which related parties acquired property and divided the interest to provide one or the other related parties an interest, the cost of which could be amortized and deducted. Section 167(r) prohibits any depreciation or am-

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corporation, and

- (B) more than 50 percent of the capital interest, or the profits interest, in the partnership;
- (11) An S corporation and another S corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
- (12) An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

*Id.* § 267(b).

Section 267(c)(4) defines family as "includ[ing] only [the taxpayer's] brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants . . . ." *Id.* § 267(c)(4).

53. I.R.C. § 1031(f)(1)(A), (f)(1)(B) (West Supp. 1990).

54. *Id.* § 1031(f)(1)(C).

55. *Id.*

56. *Id.*

57. *Id.* § 1031(f)(2)(A).

58. *Id.* § 1031(f)(2)(B) (applies on disposition pursuant to a compulsory or involuntary conversion as defined under § 1033, as long as the original exchange occurred prior to the threat or imminence of the conversion).

59. *Id.* § 1301(f)(2)(C).

60. Revenue Reconciliation Act of 1989 (CCH) ¶ 10,500.

ortization deduction for a term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.<sup>61</sup> A few definitions of the terms used in section 167(r) illustrate the prohibition.

A ““term interest” in property means a life interest in property, an interest in property for a term of years, or an income interest in a trust.”<sup>62</sup> A “related person” is broadly defined under section 267(b) and (e) but does not include in-laws.<sup>63</sup> Thus, under section 167(r), the taxpayer’s basis in a term interest will be reduced by the deductions disallowed by the provision, and the remainderman’s basis in the remainder will be increased by the amount of those disallowed deductions.<sup>64</sup> This new provision applies to interests created or acquired after July 27, 1989.

#### V. INCOME TAX WITHHOLDING ON THE WAGES OF CERTAIN AGRICULTURAL WORKERS Now REQUIRED

If an agricultural worker’s cash wages are subject to Federal Insurance Contributions Act (FICA) withholding, the agricultural worker’s cash wages are also now subject to income tax withholding.<sup>65</sup> An agricultural worker’s cash wages are subject to FICA withholding in several situations. First, if the agricultural worker earns \$150 or more, the employer now must withhold for both FICA and income tax purposes.<sup>66</sup> Second, if the employer pays \$2,500 or more in total wages for one year, FICA and income tax withholding are required for all employees, even those who are paid less than \$150.<sup>67</sup> However, if the total wages paid by a hand harvest agricultural employer in a single year are less than \$2,500, those employees receiving less than \$150 are not subject to FICA withholding.<sup>68</sup>

The ““hand harvest laborer” exception applies in any situation.<sup>69</sup> The exception provides that ““wages” do not include amounts paid if the employee is “a hand harvest laborer and is paid on a piece rate basis . . .,<sup>70</sup> commutes daily from his permanent residence to the farm . . .,<sup>71</sup> and has been employed in agriculture less than 13 weeks during the preceding

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61. I.R.C. § 167(r) (West Supp. 1990).

62. *Id.* § 1001(e)(2) (1988).

63. See *supra* note 52 (listing definition of “related persons” under I.R.C. § 267(b) (1988)); see also I.R.C. § 267(e) (1988).

64. I.R.C. § 167(r)(3)(B) (West Supp. 1990).

65. *Id.* § 3401(a)(2) (1988).

66. *Id.* § 3121(a)(8)(B)(i).

67. *Id.* § 3121(a)(8)(B)(ii).

68. *Id.*

69. *Id.*

70. *Id.* § 3121(a)(8)(B)(I).

71. *Id.* § 3121(a)(8)(B)(II).

calendar year.<sup>72</sup> However, the total paid for this labor does count toward the \$2,500 threshold test.<sup>73</sup>

Since January 1, 1988, cash wages paid to a spouse are subject to FICA tax.<sup>74</sup> Prior to that date, the wages were not FICA wages.<sup>75</sup> Since January 1, 1988, cash wages paid by a mother or father to a child under 18 years of age also are not covered FICA wages.<sup>76</sup> Prior to that date, wages paid by a mother or father to a child under 21 years of age were not covered FICA wages.<sup>77</sup> Finally, qualifying noncash wages (payments in kind) are not FICA wages.<sup>78</sup>

## VI. SELF-EMPLOYMENT TAX CALCULATION FOR 1990

The basic self-employment tax rate and sum of the employee's and employer's share of the FICA tax is 15.30% for 1990.<sup>79</sup> However, beginning in 1990, a self-employed person can deduct one-half of the self-employment tax when calculating self-employment income.<sup>80</sup> Therefore, the effective self-employment rate is  $15.30\% \times (1.00 - .0765) = 14.13\%$ . Furthermore, one-half of the self-employment tax and the employer's share of the FICA tax are an income tax deduction and therefore reduce income taxes by an amount that varies with the taxpayer's marginal income tax rate. Finally, the wage base for 1990 is \$51,300.<sup>81</sup>

## VII. SHARE LEASES AND PASSIVE LOSSES UNDER I.R.C. § 469

Regulations issued under I.R.C. § 469 include an example that describes a crop share arrangement between a landowner and tenant, and concludes that the landowner is treated as being a part of a joint venture for purposes

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72. *Id.* § 3121(a)(8)(B)(III).

73. *Id.*

74. *Id.* § 3121(a).

75. *Id.* § 3121(b)(3) (1982).

76. *Id.* § 3121(b)(3)(A) (1988).

77. *Id.* § 3121(b)(3)(A) (1982).

78. *Id.* § 3121(a)(8)(A) (1988).

79. *Id.* § 1401(a), (b).

80. See *id.* § 1402(a)(12). The section provides in part:

[I]n lieu of the deduction provided by section 164(f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction to the product of—

(A) the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph), and  
(B) one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year.

*Id.*

81. *Id.* § 1402(b).

of the passive loss rules.<sup>82</sup> That conclusion has two important implications. First, by treating the property as being used in a joint venture, the property does not qualify for the rule that allows \$25,000 of losses from rental real estate to be deducted against nonpassive income.<sup>83</sup> Second, the landowner's use of the property will be treated as a nonpassive activity or passive activity based upon whether the landowner materially participates in the farm business that uses the property.<sup>84</sup> By contrast, if the property is treated as rental real estate, material participation is irrelevant because rental real estate is irretrievably treated as a passive activity.<sup>85</sup> However, if the landowner *actively* participates in the use of the property and meets the other requirements of I.R.C. § 469(i), up to \$25,000 of losses from the property can be used to offset nonpassive income.<sup>86</sup>

Based on Example 8, the authors of this Article concluded that share leases would not be treated as rental real estate by the Internal Revenue Service.<sup>87</sup> Consequently, material participation would be an issue, and losses from a share lease would not qualify for the \$25,000 rental real estate exception. That conclusion is apparently inconsistent with the following statement from the instructions for Form 4835: "If you ACTIVELY PARTICIPATED in the operation of this activity and you show a loss on line 33c, you may be able to deduct up to \$25,000 of losses from all rental

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82. Temp. Treas. Reg. § 1.469-1T(e)(3)(viii) (1990) (Example 8) [hereinafter Example 8].

The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performed any services in the farming activity.

*Id.*

83. I.R.C. § 469(i) (1988). This section allows \$25,000 of losses from rental real estate to be deducted against nonpassive income if the taxpayer actively participates in the use of the property. *Id.* § 469(i)(1). The \$25,000 deduction is reduced by 50% of the amount by which the taxpayer's adjusted gross income exceeds \$100,000. *Id.* § 469(i)(3)(a).

84. I.R.C. § 469(c)(1) (1988). This section defines a passive activity as a trade or business in which the taxpayer does not materially participate. *Id.*

85. *Id.* § 469(c)(2).

86. *Id.* § 469(i)(1).

87. G. BOCK, C. ALLEN, & P. HARRIS, 1988 FARM INCOME TAX SCHOOL WORKBOOK, UNIVERSITY OF ILLINOIS 40-41 (1988).

real estate activities.”<sup>88</sup> The Form 4835 instructions imply that a share lease may qualify as rental real estate because only rental real estate qualifies for the \$25,000 exception.<sup>89</sup>

Michael R. Grace, the author of both Example 8 and the instructions for Form 4835, explains in a letter to the editor of *Tax Notes* that Example 8 and the instructions for Form 4835 are not inconsistent.<sup>90</sup> He argues that *some* share leases may be rental real estate and others may be joint ventures as in Example 8.<sup>91</sup> He points out that the scheme of I.R.C. § 469 requires a two-tiered test to classify a share lease as passive or nonpassive.<sup>92</sup> The first test is whether the lease is a trade or business.<sup>93</sup> If the lease is a trade or business, the second test is whether there is material participation by the taxpayer.<sup>94</sup> If the lease is not a trade or business, it is rental real estate, and the second test is whether the landowner meets the active participation and other requirements of I.R.C. § 469 to qualify for the \$25,000 rental real estate allowance.<sup>95</sup>

Although Grace’s two-tiered test appears to be the general rule for classifying property as passive or nonpassive under I.R.C. § 469, the question is whether Congress intended the general rules of I.R.C. § 469 to apply to crop share leases. In an earlier letter to the editor of *Tax Notes*, Neil Harl points out that prior to the passive loss rules, most authorities treated a material participation share lease as a business and a nonmaterial participation share lease as a rental activity.<sup>96</sup> Therefore, Congress must have intended to treat share leases differently for passive loss purposes than for all other tax purposes (such as I.R.C. §§ 1402 and 2032A) if Grace is correct that the two-tiered test is to be applied to share leases. It is possible that Congress intended such a change, but as Charles Davenport points out in still another letter to the editor of *Tax Notes*,<sup>97</sup> there is very little legislative history to support Grace’s argument that Congress intended to apply a new rule to share leases.

If the two-tiered test is applied to share leases, very few share leases will be treated as rental real estate. Grace states:

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88. 1990 I.R.S. Form 4835, p. 2 (emphasis in original).

89. An earlier statement in the instructions for the 1990 Form 4835 states that share lease income and expenses should be reported on Form 4835 only if the lease “is a rental activity for purposes of the passive activity loss limitations.” *Id.*

90. 49 TAX NOTES 1587 (Dec. 31, 1990).

91. *Id.*

92. *Id.*

93. *Id.*; *see* I.R.C. § 469(c)(1)(A) (1988).

94. 49 TAX NOTES 1587 (Dec. 31, 1990); *see* I.R.C. § 469(c)(1)(B) (1988).

95. I.R.C. § 469(i) (1988).

96. 49 TAX NOTES 1255 (Dec. 10, 1990).

97. 50 TAX NOTES 93, 93-96 (Jan. 7, 1991).

A crop share lease might appropriately be viewed as a rental activity if the land provider's potential benefits and risks are more limited than in a 50-50 joint venture, and payment for the use of land does not depend or depends less on the tenant's efforts, the production from the land, or the results of marketing crops.<sup>98</sup>

Because the nature of a share lease is to make the land owner's remuneration dependent on production and, in most cases, the price of the commodity, very few share leases would meet Grace's statement of the test for rental real estate treatment. Therefore, as a practical matter, Grace's approach treats share leases as a joint venture,<sup>99</sup> and therefore makes them ineligible for the \$25,000 exclusion.

By contrast, if share leases are treated the same under the passive loss rules as they are for purposes of I.R.C. §§ 1402 and 2032A, only one question has to be answered to categorize the lease as passive or nonpassive. That question is whether the landowner materially participates in the use of the property. If the answer is yes, the lease is a trade or business and nonpassive. If the answer is no, the lease is rental real estate and qualifies for the \$25,000 exception. The result of this approach is that no share leases fall into the middle position of being a trade or business without material participation. Consequently, no share lease is passive without the benefit of the \$25,000 exception.

Based on the above discussion, the I.R.S. can take the position that a landowner who does not materially participate in a share lease arrangement is subject to the passive loss limitations without the benefit of the \$25,000 exception. A taxpayer who wants to resist that conclusion has two arguments. First, the taxpayer may argue that Congress intended to classify share leases as passive or nonpassive using the rules of prior law. If there is no material participation, the lease is rental real estate and the taxpayer may qualify for the \$25,000 exception. If the first argument fails, the taxpayer may argue that his or her remuneration from the lease depends less on the tenant's efforts, the production from the land, or the results of marketing than the 50-50 joint venture in Example 8. Therefore, the share lease is rental real estate and qualifies for the \$25,000 exception.

## VIII. RENT PAID TO A SPOUSE

### A. *Introduction*

One means of reducing a farm family's social security taxes is to pay rent to the nonfarming spouse for the spouse's share of the farm property.

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98. 49 TAX NOTES 1587, 1588 (Dec. 31, 1990).

99. See *supra* note 97, at 93-96.

The rent paid is deducted on the farmer's Schedule F, and therefore reduces self-employment taxes. Additionally, if the farmer's spouse does not materially participate in the farm business, the new rental income is reported on Schedule E, and therefore is not subject to self-employment taxes.

The I.R.S. has attacked this means of reducing social security taxes in the course of auditing farm income tax returns. Two arguments against allowing the deduction of rent paid to a spouse exist. First, the I.R.S. argues that the rent agreement is not an arm's length transaction, and therefore is not deductible.<sup>100</sup> Second, the I.R.S. argues that the rent-paying farmer has "equity" in the property, and therefore cannot deduct the rent.<sup>101</sup>

### *B. Rebutting the Arm's Length Argument*

The I.R.S.'s first argument, that paying rent to a spouse is not an arm's length transaction, confuses the existence of control with the use of the control to distort the meaning of income. The I.R.S. regulation dealing with the allocation of income and deductions among taxpayers states: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."<sup>102</sup> Thus, with rent paid to a spouse, the issue is whether the same rent would have been paid to an unrelated taxpayer. In other words, if the rent claimed as a deduction is a fair rental rate for the spouse's interest in the property, the farm operator may deduct it.

In several cases supporting this reasoning, courts have held that rent paid to a married couple who owned property as joint tenants is divided between the spouses for purposes of federal income taxes.<sup>103</sup> Similarly, courts have held that interest earned on a note held jointly by husband and wife is to be divided between them.<sup>104</sup>

In a few cases, however, courts have ignored state law, and have taxed income to the party who had "control" of the income rather than the party who had legal title to the income.<sup>105</sup> In those cases, however, the taxpayer in "control" had made a gift to the other taxpayer.<sup>106</sup>

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100. See I.R.C. § 482 (1988) (secretary given power to "distribute, apportion, or allocate . . . deductions" if it is determined that it is necessary to prevent tax evasion or to more clearly reflect the income of the parties).

101. See *id.* § 162(a)(3) (rent may be claimed as deduction when paid on "property . . . in which [the taxpayer] has no equity").

102. Treas. Reg. § 1.482-1(b)(1) (as amended in 1968).

103. See, e.g., *Tracy v. Commissioner*, 25 B.T.A. 1055 (1932), *rev'd*, 70 F.2d 93 (6th Cir. 1934).

104. See, e.g., *Haynes v. Commissioner*, 7 B.T.A. 465 (1927).

105. See, e.g., *Lannan v. Kelm*, 221 F.2d 725 (8th Cir. 1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951).

106. *Lannan*, 221 F.2d at 729-30; *White*, 193 F.2d at 400.

These cases in which courts have ignored the legal obligations of the parties may be distinguished by a farmer wishing to argue that the rent paid to the farmer's spouse should be deductible. First, many farmers may argue that the joint tenancy was not created as a gift. Second, those cases in which the courts have ignored the legal obligations of the parties arguably err in reassigning income away from the legal owner of an asset that plays a material role in generating income.<sup>107</sup>

Moreover, in attacking payments made to a joint tenant, the I.R.S. adds to a long line of failed attempts to attack payments to a tenant-in-common, payments to a partner of a farm operated as a partnership,<sup>108</sup> payments to a shareholder of a farm operated by a corporation, and payments in many other related-party cases.<sup>109</sup> For instance, in *Interior Securities Corp. v. Commissioner*<sup>110</sup> the court rejected the Commissioner's arguments that a partnership was a sham and that rental income should be reallocated under section 482.<sup>111</sup> The court stated, "But common control alone is not sufficient to justify the application of this section. . . . It is only where there is a shifting of income from one controlled unit to another that any allocation is justified under section 482."<sup>112</sup> Similarly, in two different cases involving the same taxpayer,<sup>113</sup> the court rejected the Commissioner's argument that rental income should be reallocated from a corporation to its shareholders because the amount of rent paid was consistent with an arm's length transaction.

Thus, courts should focus on the legal obligations of the parties in determining whether the rental agreement is an arm's length transaction. Likewise, taxpayers should argue that payments of rent in a joint tenancy are distinguishable from payments of dividends to corporate shareholders in a farm or payments to tenants-in-common.

### C. Rebutting the Equity Argument

Section 162(a)(3) provides that rent can be claimed as a deduction when paid on "property . . . in which [the taxpayer] has no equity."<sup>114</sup> The I.R.S.'s second argument against spousal rent payment deductions is

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107. See, e.g., *White*, 193 F.2d at 403 (Chase, J., dissenting).

108. See, e.g., *Interior Securities Corp. v. Commissioner*, 38 T.C. 330 (1962).

109. See, e.g., *Carroll v. Commissioner*, 52 T.C.M. (CCH) 1523 (1987); *Carroll v. Commissioner*, 37 T.C.M. (CCH) 736 (1978).

110. 38 T.C. 330 (1962).

111. *Id.* at 339-40.

112. *Id.* at 339 (citation to *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231, *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953) omitted).

113. *Carroll v. Commissioner*, 52 T.C.M. (CCH) 1523 (1987); *Carroll v. Commissioner*, 37 T.C.M. (CCH) 736 (1978).

114. I.R.C. § 162(a)(3) (1988).

that the taxpayer cannot deduct rent paid to a spouse who owns the other share in tenancy-in-common property because the taxpayer has "equity" in that property. That argument appears to misinterpret the use of the term "equity" in section 162(a)(3).<sup>115</sup>

In *Mathews v. Commissioner*,<sup>116</sup> the court explained that the purpose of section 162(a)(3) is to distinguish payments made to purchase property (which are not deductible but are added to basis) from payments that are made to rent property (which are deductible).<sup>117</sup> Consequently, the court concluded that the species of equity that is fatal to a rent deduction is that acquired from the lessor.<sup>118</sup> Likewise, because a farmer who is renting property from his or her spouse does not acquire equity from a spouse, the farmer does not have the fatal equity according to the *Mathews* analysis.<sup>119</sup>

Unfortunately, the *Mathews* analysis is somewhat academic because the Fifth Circuit reversed the tax court in *Mathews v. Commissioner*.<sup>120</sup> The Fifth Circuit opinion in *Mathews* supports the I.R.S. position by asserting that legal rights can be ignored when determining tax consequences. The court stated, "If we stood at the top of the world and looked down on this transaction ignoring the flyspeck of legal title under state law we would see the same state of affairs the day after the trust was created that we saw the day before."<sup>121</sup>

The Fifth Circuit's opinion in *Mathews* can be distinguished factually from most cases. In *Mathews*, the rent was paid to a trust that, in the court's view, was controlled by the taxpayer.<sup>122</sup> In the instance of land owned by the farmer's spouse in joint tenancy, the spouse has a legal right to collect rent — a right that can be enforced against the wishes of the farmer. The control factor present in *Mathews* does not exist in most joint tenancy agreements.

Additionally, *Quinlivan v. Commissioner*<sup>123</sup> cited the tax court opinion in *Mathews* with approval. The *Quinlivan* opinion discusses the split among the courts of appeals on the deductibility of rent paid to a trust set up by the taxpayer, and concludes that the majority view is that the rent is deductible if four requirements are met.<sup>124</sup> First, the taxpayer must not

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115. *Id.*

116. 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

117. *Id.* at 15-16.

118. *Id.* at 23.

119. *Id.* at 15-16.

120. 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

121. *Id.* at 328.

122. *Id.*

123. 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

124. *Id.* at 272-73.

retain the same control over the property as that had before the property was given to the trust.<sup>125</sup> Second, the leaseback should be in writing and must require payment of reasonable rent.<sup>126</sup> Third, the leaseback must have a bona fide business purpose.<sup>127</sup> Fourth, the taxpayer must not possess a disqualifying equity in the property within the meaning of the statute.<sup>128</sup>

The requirements listed in *Quinlivan* suggest the following guidelines for renting property from a spouse. Preferably, the lease should be in writing, but at minimum the farmer and spouse should agree upon a rental rate before the lease term. Most importantly, the rental rate should be a fair rental rate.

Other arguments against the I.R.S. position exist. In Revenue Ruling 74-209, the I.R.S. concluded that rent paid by a husband to his wife for the use of their jointly-owned Wisconsin real estate that the husband used in his business was deductible as a business expense on the husband's separate income tax return.<sup>129</sup> On its face, this ruling seems to reject the equity argument of the I.R.S.

However, in two letter rulings,<sup>130</sup> the I.R.S. distinguished Revenue Ruling 74-209 by the fact that the taxpayers in the letter rulings filed a joint return rather than a separate return. The two distinguishing letter rulings concluded that filing a joint return makes the two taxpayers one taxable unit; therefore, the payment from husband to wife had no substance because the taxable unit merely reallocated income within itself.<sup>131</sup>

This position does not necessarily follow from the authorities the I.R.S. cites to support its position. In Private Letter Ruling 85-35-001, the I.R.S. cited *Helvering v. Janney*<sup>132</sup> to support its holding that when a married couple files a joint return, one spouse is not allowed to deduct payments made to the other spouse because they have become one taxable unit. *Helvering v. Janney*<sup>133</sup> addressed whether capital losses of one spouse could be deducted against capital gains of the other spouse. In holding that spouses could deduct capital losses, the Court pointed out that on a joint return, tax is computed on the aggregate income of the two taxpayers, which is calculated by deducting one spouse's excess deductions from the

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125. *Id.* at 272.

126. *Id.*

127. *Id.*

128. *Id.*

129. Rev. Rul. 74-209, 1974-1 C.B. 46.

130. Priv. Ltr. Rul. 85-35-0001 (May 3, 1985) (husband paid wife for bookkeeping services); Priv. Ltr. Rul. 81-04-004 (Sept. 23, 1980) (husband paid wife rent for her separate property).

131. See *supra* note 130.

132. 311 U.S. 189 (1940).

133. *Id.*

other spouse's net income.<sup>134</sup> Thus, the issue of allowing a deduction for payments made by one spouse to the other was not before the Court, and was not addressed by the Court. The case does not lend credence to Private Letter Ruling 85-35-001.<sup>135</sup>

The taxable unit concept derived from filing a joint return has been explicitly rejected in other contexts. In *Coerver v. Commissioner*,<sup>136</sup> the tax court discussed *Helvering v. Janney*<sup>137</sup> and *Taft v. Helvering*,<sup>138</sup> and rejected the taxpayer's argument that those cases hold that a married couple filing jointly becomes one taxpayer for all purposes.<sup>139</sup> The court rejected the taxpayer's argument that filing a joint return made them a taxable unit and therefore that their tax home was in the city where the husband lived and worked:

The concept of a "taxable unit" under the joint return provision, § 6013, merely means that while there are two taxpayers on a joint return, there is only one taxable income. It does not create a new tax personality which would be entitled, in its own right, to deductions not otherwise available to the individual spouses under the pertinent sections of the statute.<sup>140</sup>

In Private Letter Ruling 85-35-001, the I.R.S. also cites three cases in which the taxpayers created trusts for the benefit of their minor children, conveyed an office building to the trusts, and then rented the office building from the trust for a medical practice.<sup>141</sup> In each of those cases, the court examined the nature of the transaction, and concluded that it had no economic substance because the taxpayer had economic control of the building before and after the transfer, the amount of rent that was paid was not set at a fair rental rate, and there was no written lease specifying the rent.<sup>142</sup> Rent paid to a spouse can be distinguished from those facts because a spouse who is a joint tenant has the legal right to collect his or her share of rent from the property. Therefore, if the standard of these three cases is applied, the rental deduction should be allowed.

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134. *Id.* at 192.

135. See also *Taft v. Helvering*, 311 U.S. 195 (1940).

136. 36 T.C. 252 (1961), *aff'd*, 297 F.2d 837 (3d Cir. 1962).

137. 311 U.S. 189 (1940).

138. 311 U.S. 195 (1940).

139. *Id.* at 254.

140. *Id.*

141. *Penn v. Commissioner*, 51 T.C. 144 (1968); *Furman v. Commissioner*, 45 T.C. 360 (1966), *aff'd*, 381 F.2d 22 (5th Cir. 1967); *Van Zandt v. Commissioner*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

142. *Furman*, 45 T.C. at 364-66; *Penn*, 51 T.C. at 151-54; *Van Zandt*, 40 T.C. at 830-31.

In addition, the I.R.S. did not follow the conclusion of Private Letter Rulings 85-35-001 and 81-04-004 that filing a joint return created a single taxable unit.<sup>143</sup> In Private Letter Ruling 87-42-007, the husband and wife filed a joint return, and the husband was allowed to deduct wages paid to his wife on his Schedule F.<sup>144</sup> Because the taxable unit concept is not discussed in the ruling, it is impossible to know if the I.R.S. has abandoned or merely forgotten that argument at the time of writing the later ruling.

Finally, if rent has not been paid to the farmer's spouse for many years and then rent is paid, the I.R.S. potentially could argue that the rental payments are illusory. The taxpayer can refute such an argument by pointing out that a spouse's failure to collect rent in past years does not prevent the spouse from collecting rent for the current and future years.

#### *D. Conclusion*

In many farm families, the farmer's spouse owns an interest in some or all of the land used in the farm business. Regardless of whether that ownership is in the spouse's name alone or as a co-owner with the farmer in the form of a tenancy-in-common, joint tenancy, tenancy-by-the-entirety, or community property, the farmer's spouse has a right to collect rent on his or her share of the property. Therefore, payment of fair-market rent by the farmer to the spouse according to a bona fide rental agreement should be allowed as a deduction on the farmer's Schedule F, which will reduce self-employment taxes if the farmer's FICA wages and self-employment income are below the social security base income. If the farmer's spouse does not materially participate in the farm business, the rental income should be reported on Schedule E where it is not subject to the self-employment tax.

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143. Priv. Ltr. Rul. 87-42-007 (June 26, 1987).

144. *Id.*



# Analysis of the Farmer's Comprehensive Liability Policy

JOHN D. COPELAND\*

## I. INTRODUCTION - OVERVIEW OF LIABILITY PROBLEMS

Farming is an inherently dangerous activity that ranks only behind subsurface mining in danger to its participants.<sup>1</sup> Not only is farming dangerous to those who practice it, but farming also carries with it the risk of injury or damage to other persons and their property. Because of the risks associated with farming, the potential legal liability arising out of agricultural activities and land ownership is enormous. The following is a brief sketch of such potential liability.

### *A. Misuse of Chemicals*

The use of chemicals to control weeds, insects, and other pests is prevalent in modern farming.<sup>2</sup> Although the use of chemicals is responsible for much of modern agriculture's productivity, such chemicals as pesticides, herbicides, and other chemicals may cause harm to people or their property if the chemicals reach areas other than their targeted designations. Because of the dangers associated with farm chemicals, farmers must take reasonable precautions in their use. Failure to do so may cause injury to neighbors and their property as a result of chemical drift or pollution. A number of states have imposed strict liability on farmers whose chemicals have caused damage to others.<sup>3</sup>

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1. There were 1,300 agricultural work deaths in 1989, of which 700 involved farm residents in farm work and 600 involved nonfarm residents working on farms and anyone working in other industries classified as agriculture. The corresponding injury totals were 120,000 in agricultural work — 70,000 to farm residents and 50,000 to others.

NATIONAL SAFETY COUNCIL, ACCIDENT FACTS 100 (1990).

2. J. LOONEY, J. WILDER, S. BROWNBACK & J. WADLEY, AGRICULTURAL LAW: A LAWYER'S GUIDE TO REPRESENTING FARM CLIENTS 591-93 (1990).

3. *Id.*

### *B. Injury to Farm Visitors*

Farmers frequently have other persons on their land. The extent of the farmer's duty to protect such persons depends on the legal status of the visitor. For example, some visitors may be invitees. An invitee is one who is on the land for a business purpose. A landowner owes an invitee the highest duty of care. The landowner must warn the invitee against any dangerous conditions existing on the land and must take reasonable precautions to inspect the premises periodically to discover dangers.<sup>4</sup> Invitees include persons who enter the property for hunting, fishing, and camping purposes and are charged a fee for such use. Persons entering the property to purchase the farmer's products are also invitees.

Some visitors are classified as licensees. Licensees are persons who enter or remain on the land with the owner's consent for nonbusiness purposes. The farmer is obligated to use reasonable care to protect the safety of the licensee, and must warn the licensee of known dangers.<sup>5</sup> Licensees include social guests and recreational users of the farmer's land, so long as they are not charged a fee.

Finally, the landowner even owes a limited duty to trespassers. Trespassers are those who enter or remain on the land without the possessor's consent. Even to trespassers, the farmer owes a duty to refrain from committing willful, malicious, or reckless injury. There is, however, no duty to make land generally safe for trespassers.<sup>6</sup>

### *C. Escaping Animals*

Possessors of land have a duty to keep their animals properly fenced. The failure to keep fences in good repair can result in escaping livestock, causing injury to neighboring persons and their property for which the farmer is legally liable. Under the doctrine of strict liability, which is applicable to dangerous animals, even a landowner who has exercised careful control over the animals may be liable for any damage caused by escaping animals.<sup>7</sup>

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4. Olexa & Mack, *Introduction to Basics of Law Relative to Natural Resources Enterprises*, in NATURAL RESOURCES MANAGEMENT AND INCOME OPPORTUNITY SERIES: LEGAL ISSUES 2-3 (1990) (available through the National Center for Agricultural Law Research and Information, University of Arkansas).

5. *Id.*

6. *Id.*

7. See Bottrell, Johnson, & Anderson, *Liability and Farm Liability Insurance*, AGRIC. ECON. MISCELLANEOUS REP. No. 60, at 2 (a joint report of the Department of Agriculture Economics, North Dakota State University, Fargo, ND and The University of North Dakota School of Law, Grand Forks, ND) [hereinafter AGRIC. ECON. REP. No. 60].

#### *D. Motor Vehicle Liability*

Modern agriculture is highly mechanized. The use of motor vehicles and heavy equipment in everyday farming activities involves potential liability for injuries or damages caused by careless operation.<sup>8</sup>

#### *E. Liability for Agricultural Employees*

Farmers frequently employ laborers. As an employer, the farmer may be held responsible for the negligent conduct of employees who harm third parties. If an employee injures a third party while the employee is acting within the course and scope of employment, the farmer potentially faces vicarious liability.<sup>9</sup>

#### *F. Liability to Employees*

Not only does the farmer have responsibility for the actions of his employees, but he is responsible for their protection. Farmers must provide employees with safe tools and equipment and a safe and suitable place to work. Farmers must use reasonable care in selecting employees and must properly instruct employees in the dangers associated with their work, including the care of animals and equipment. Failure to fulfill these duties exposes the farmer, as an employer, to potential liability. If the farmer's employees are not covered under state workers' compensation law, the farmer faces liability for the injured employee.<sup>10</sup>

The foregoing is only a sample of the liability problems that farmers face. Because a farmer can be financially ruined by a large personal injury or property damage judgment, the farmer should reduce, as much as possible, any potential financial exposure. The primary means of eliminating, or at least reducing, the risk of loss is through liability insurance.

The Farmer's Comprehensive Liability Policy (FCLP) is the most common liability policy for farmers. The policy is designed to meet the specific needs of farmers, and necessarily includes a combination of coverages including comprehensive personal liability, employer's liability, and use of powered equipment. Although many farmers have FCLPs, very few fully understand the nature and extent of the coverage provided by the standard FCLP. This Article discusses the more common provisions found in the standard FCLP and the problems arising under those provisions.

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8. *Id.* at 9.

9. *Id.* at 12.

10. *Id.* at 12-13.

## II. SOME INSURANCE LAW BASICS

The first thing a farmer must understand about an FCLP is that it is subject to the same rules, regulations, limitations, and court interpretations as any other liability policy. Insurance is nothing more than a means of transferring or allocating risk. In exchange for consideration (a premium) paid by the insured, the insurer assumes the insured's risk by making a series of promises to the insured.

### *A. Promise to Indemnify*

Liability insurance is primarily concerned with the insured's legal liability for injuries to others or for damage to another person's property. The insurer typically promises that: "The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence."<sup>11</sup>

"Bodily injury" is defined as bodily injury, sickness, or disease sustained by any person during the policy period, including death resulting therefrom.<sup>12</sup> "Property damage" is defined as physical injury to or destruction of tangible property occurring during the policy period, including loss of property use.<sup>13</sup>

However, the insurer's obligation to pay for personal injuries or property damage is conditioned on an occurrence. Virtually all modern liability insurance policies are written on an occurrence basis. Occurrence is a term of art which is generally defined as an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended by the insured. Unless there is an occurrence, there is no coverage under the liability policy.<sup>14</sup>

Generally, an accident is not defined within the terms of the policy. The courts, however, have defined "accident" as a fortuitous event that

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11. Fireman's Fund Insurance Companies, § I. Coverage L-Personal Liability (re-citing specimen FCLP).

In 1985, the Insurance Service Office (ISO) rewrote and simplified the language of the FCLP. ISO is a national, nonprofit corporation that assists insurance companies in the preparation of insurance policies and programs. Insurance companies that have adopted the new policy language use the following clause: "We will pay those sums that the 'insured' becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies." See Commercial Lines Manual, Division Four, Farm, FL-00-20-10-88, Coverage H-Bodily Injury and Property Damage Liability § 1a (Copyright, Insurance Services Office, Inc. 1985, 1988) [hereinafter ISO, FL-00-20-10-88].

12. Rhodes, *General Liability Insurance, THE LAW OF LIABILITY INSURANCE* 10-11 (1989).

13. *Id.*

14. *Id.* at 10-9.

is neither expected nor intended by the insured.<sup>15</sup> Intentional acts, such as assaults, are outside policy coverage even if the policy has no specific exclusion as to such an event.<sup>16</sup>

Occurrences include spontaneous events, such as automobile collisions, as well as injuries or damages sustained over an extended period of time. Bodily injury or property damage triggers the occurrence, and the loss must occur within the effective dates of the policy.<sup>17</sup>

Besides obligating the insurer to pay the insured's liability to third parties, the policy also obligates the insurer to pay expenses incurred by the insured in any suit the insured defends, including such costs as required bonds or premiums, postjudgment interest and prejudgment interest awarded against the insured. However, all of this is done within the confines of the insurer's policy limits as stated on the declarations page.<sup>18</sup>

#### *B. Promise to Defend*

The second promise made by the insurer is to defend the insured in any lawsuit brought by a third party alleging liability covered by the policy. The insurer promises to defend the insured within the scope of the policy. An example of such a provision follows:

[A]nd the insurer shall have the right and duty to defend any suit against the insured seeking damages . . . , even if any of the allegations of the suit are groundless, false or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient.<sup>19</sup>

In a sense, liability insurance is also litigation insurance. The duty to defend is a greater duty than the duty to pay proceeds. The duty to defend is owed unless the insurer establishes that the facts contained in the lawsuit fall within an applicable policy exclusion.<sup>20</sup>

#### *C. Limitations on the Duties to Defend and Indemnify*

Although the standard personal liability insurance policy contains broad language as to the insurer's duties to indemnify and defend the

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15. *Id.*

16. *Id.*

17. *Id.* at 10-10.

18. R. JERRY, II, *UNDERSTANDING INSURANCE LAW* 456-57 (1987).

19. Fireman's Fund Insurance Companies, *supra* note 11. The new ISO material states as follows: "We will have the right and duty to defend any 'suit' seeking those damages. We may at our discretion investigate any 'occurrence' and settle any claim or 'suit' that may result." ISO, FL-00-20-10-88, *supra* note 11.

20. See R. JERRY, II, *supra* note 18, at 561-87 for a complete explanation of the duty to defend.

insured, the language is naturally limited by provisions within the policy. These limitations are established by:

1. The duties imposed on the insured with respect to the payment of premiums, the giving of notice in the event of accidents or occurrences, and cooperation with the insurance company;
2. The identification of particular areas of activity not covered by the policy;
3. The specific coverage exclusions;
4. The limitations on the period of time in which coverage exists; and
5. The dollar limitations on the amount of damages.<sup>21</sup>

#### *D. Construction of Policies*

The basic principles governing the construction of insurance contracts are fully applicable to the farmer's comprehensive liability policy, even though the policies are specifically designed to meet and protect the somewhat specialized needs of farmers.<sup>22</sup> Generally speaking, the following rules of construction favor the insured in an insurance coverage dispute with the insurer:

1. As with any contract, the insurance agreement must be enforced according to its terms.
2. Insurance policies are to be construed in their entirety, and no greater significance shall be given to any single provision of the policy.
3. All insurance policies must be interpreted according to the purposes and hazards against which the policy was designed to protect.
4. It is the obligation of the insurer to clearly define in explicit terms any limitations or exclusions to coverage expressed in the contract.
5. In interpreting insurance contracts, the words of the policy must be measured by the reasonable expectations of the insured.

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21. The following is an example of such a provision: "But: (1) The amount we will pay for damages is limited as described in SECTION 11-LIMITS OF INSURANCE; and (2) Our right and duty to defend ends when we have used up the applicable Limit of Insurance in the payment of judgements or settlements." ISO, FL-00-20-10-88, *supra* note 11 (capitals in the original).

22. Isaac v. Reliance Ins. Co., 201 Kan. 288, 293, 440 P.2d 600, 604-05 (1968).

6. Any ambiguities in the contract must be construed in favor of the insured.
7. Language is ambiguous when the language is susceptible to two or more meanings by a reasonably prudent person.
8. If contractual language is ambiguous, extrinsic evidence may be used to show the intention of the parties.
9. Plain and unambiguous language contained in the contract must be given its fair and natural meaning.
10. Parole evidence is inadmissible to contradict, supplement, or vary a written contract that is clear, and explicit and contains no ambiguities.<sup>23</sup>

In purchasing an FCLP, the farmer must be cognizant of the following considerations:

1. What persons are insured under the policy;
2. What activities of those persons are insured;
3. Are there any limits on where those activities can be performed; and
4. What exclusions contained in the policy may limit my coverage?

### III. PERSONS COVERED

#### A. *Named Insureds and Additional Insureds*

"[T]he 'insured' is the person whose loss triggers the insurer's duty to pay proceeds."<sup>24</sup> The named insured is the person specifically designated as an insured under the policy. However, liability policies often designate not only a named insured, but also other insureds by description. The other insureds are usually classes of people who have some relationship to the named insured, such as family members, household residents, and any other persons under the age of twenty-one in the insured's care.<sup>25</sup>

Many of the more recently written FCLPs also make it clear that "insured" includes not only the named insured, but also any partnerships or joint ventures in which the insured is involved, including the spouse of any partners, but only with respect to conducting farming operations. Furthermore, other organizations to which the insured may belong,

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23. D. DEY & S. RAY, ANNOTATED COMPREHENSIVE GENERAL LIABILITY INSURANCE POLICY 111-18 (1984).

24. R. JERRY, II, *supra* note 18, at 211.

25. *Id.* at 211-18.

including corporate ventures, are also included if they are connected with farming operations. If the corporation is covered under the policy, all executive officers and directors are also insured. Stockholders are also covered, but only for their liability as stockholders.<sup>26</sup>

The liability policy protects all those persons who qualify as insureds against liability claims of third parties for bodily injury or property damage arising out of an insured's negligence. This means that the insurer owes both the named insured and the additional insureds the duties of indemnification and defense. Although these additional insureds may be provided liability protection as to third-party claims, often they are excluded from coverage for claims they might have against the named insured.

### *B. Household Exclusion*

Many FCLPs contain what is commonly known as the family or household exclusion. This exclusion provides no coverage for members of the insured's household for any bodily-injury liability claims against the named insured. For example, if the insured's son negligently drives a tractor and injures a third party, there is typically insurance coverage for the accident. However, if a similar accident occurs in which the named insured injures his own son, the son is not covered under the policy if a family exclusion exists.

Family exclusions are criticized on public policy grounds, especially in automobile accident cases. Critics argue that the clause unfairly excludes coverage from those persons most likely to be injured by acts of negligence. Some argue that the clause is unconscionable because most insurance buyers are unaware of the exclusion and its coverage limitation. Supporters of the exclusion, primarily the insurance industry, argue that the clause is necessary to promote family harmony and to avoid collusive lawsuits.<sup>27</sup> Some jurisdictions have stricken the clause on public policy grounds,<sup>28</sup> but many jurisdictions still permit family ex-

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26. FIRE CASUALTY AND SURETY BULLETINS, Aug. 1990, at Farms Ap-3, Mar. 1990, at Public Liability Ad-1 [hereinafter FC&S BULLETINS].

27. R. JERRY, II, *supra* note 18, at 676-78. See also Note, *Family Exclusion Clauses Void in Automobile Insurance Policies*, 35 DRAKE L. REV. 817 (1986-87); Comment, *Family Exclusion Clauses: Whatever Happened to the Abrogation of Intrafamily Immunity?*, 21 SAN DIEGO L. REV. 415 (1984); Note, *The Household Exclusion Clause - Returning to the Days of Family Immunity*, 7 HAMLINE L. REV. 507 (1983).

28. See, e.g., Jennings v. Government Employees Ins. Co., 302 Md. 352, 488 A.2d 166 (1985); Meyer v. State Farm Mut. Auto. Ins. Co., 689 P.2d 585 (Colo. 1984); Mutual of Enumclaw Ins. Co. v. Wiscomb, 97 Wash. 2d 203, 643 P.2d 441 (1982); Allstate Ins. Co. v. Wyoming Ins. Dep't, 672 P.2d 810 (Wyo. 1983).

clusion clauses in liability policies.<sup>29</sup> Such clauses have a significant impact on liability claims.

For example, in *National Farmer's Union Property and Casualty Co. v. Maca*,<sup>30</sup> the insured's adult son was injured while operating a corn picker on the insured's property. The son filed a lawsuit against his father alleging negligence. The insurance company refused to recognize coverage because the son was excluded from coverage under the FCLP's family exclusion provision.<sup>31</sup> The father and son argued that the son was only temporarily residing at the father's home, had no intention of becoming a permanent resident of the household, was not a member of the household, and would eventually move out.<sup>32</sup> The court, however, sustained the insurance company's position and found that the son was a resident of the father's household because he lived there, took his meals there, and even though he planned to leave, his plans were indefinite, and there was a sense of permanence about the matter.<sup>33</sup>

Similarly in *Goller v. White*,<sup>34</sup> injuries to a twelve-year-old foster child, suffered while riding on the insured's tractor, were not covered because of the household exclusion. The child's temporary stay at the insured's residence was enough to bring the incident under the household exclusion.<sup>35</sup>

However, an Illinois court reached a different result in *Country Mutual Insurance Co. v. Watson*.<sup>36</sup> The insured's foster child was injured while cutting string on hay bales. The insured's FCLP contained a household exclusion which was pleaded by the insurance company as a defense to any cause of action under the policy. The court found, however, that the boy's stay at the insured's home was of a temporary nature and that the critical element of intention to make the home his permanent abode was lacking. The court concluded that the foster child was not a resident of the household, and therefore the household exclusion did not apply.<sup>37</sup>

### C. Coverage Concerning Employees

1. *Actions of Employees.*—A key feature of any FCLP is liability coverage for negligence of the insured's employees. FCLPs commonly define employees as insureds under the insurance policy:

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29. See, e.g., *Cook v. Wausau Underwriters Ins. Co.*, 299 Ark. 520, 772 S.W.2d 614 (1989); *Walker v. American Family Mut. Ins. Co.*, 340 N.W.2d 599 (Iowa 1983).

30. 26 Wis. 2d 399, 132 N.W.2d 517 (1965).

31. *Id.* at 403, 132 N.W.2d at 518.

32. *Id.* at 407, 132 N.W.2d at 521.

33. *Id.* at 408, 132 N.W.2d at 521-22.

34. 20 Wis. 2d 402, 122 N.W.2d 193 (1963).

35. *Id.* at 407-09, 122 N.W.2d at 195-96.

36. 1 Ill. App. 3d 662, 274 N.E.2d 136 (1971).

37. *Id.* at 670, 274 N.E.2d at 138.

“[F]arm employee” means an employee of any insured whose duties are principally in connection with the farming operations of the insured including the maintenance or use of automobiles or teams, but does not include a residence employee or an employee while engaged in an insured’s business other than farming.<sup>38</sup>

However, disputes frequently arise as to whether the worker is actually an employee. In *Savoie v. Fireman’s Fund Insurance Co.*,<sup>39</sup> the insured’s cousin often assisted the insured in cutting and baling hay. While the insured’s cousin was driving a tractor, the insured’s daughter was thrown off the tractor and was killed. The insured’s policy covered liability of employees. However, a court denied coverage on the basis that the cousin was not an employee. The court found that the cousin was not an employee within the FCLP because the insured lacked control over the cousin’s actions and paid no wages or other compensation to the cousin.<sup>40</sup>

Even if the worker is clearly the insured’s employee, disputes may still arise when the policy covers only those actions taken by the employee during the course and scope of employment. In *Commercial Union Insurance Co. of New York v. St. Paul Fire & Marine Insurance Co.*,<sup>41</sup> the court held that the actions of an insured farmer’s employee who negligently drove a farm tractor onto a highway and killed three people in a collision with an automobile were not covered.<sup>42</sup> The court found no coverage because the worker stopped working to get something to eat.<sup>43</sup>

## 2. *Farm Employer’s Liabilities.*—

### a. *Exclusion of employees*

Although the FCLP protects the insured farmer or rancher from the claims of third parties injured by the negligent conduct of the farmer’s employees, the employees are not always financially protected from the negligent conduct of their employer. Many policies provide that the insurer is not liable for bodily injury to any farm employee or is not liable unless the employee is specifically designated as covered in the

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38. This clause is taken from the definitions section of an FCLP issued by Fireman’s Fund Insurance Companies. The new ISO language is: “‘Farm employee’ means any ‘insured’s’ employee whose duties are principally in connection with the maintenance or use of the ‘insured locations’ as a farm. These duties include the maintenance or use of the ‘insured’s’ farm equipment.” ISO, FL-00-20-10-88, *supra* note 11, § IV-Definitions.

39. 339 So. 2d 914 (La. App. 1976), *aff’d*, 347 So. 2d 188 (La. 1977).

40. *Id.* at 916-17.

41. 211 Va. 373, 177 S.E.2d 625 (1970).

42. *Id.* at 376-77, 177 S.E.2d at 628.

43. *Id.*

policy.<sup>44</sup> Such an exclusion places both the employee and employer at risk because lack of insurance funds may severely affect both parties. As a result, there is often conflict between the insurer, the insured, and the injured party as to whether the injured party is an employee.

*Austin-St. Paul Mutual Insurance Co. v. Belshan*<sup>45</sup> involved an FCLP that excluded bodily injury coverage for any farm employee. The insured hired a worker to mow hay on the insured's farm. During a work break, the worker assisted the insured to repair a piece of broken machinery. While helping with the repairs, a piece of metal struck the worker in the eye. The Minnesota Supreme Court held that the employee exclusion did not apply because the worker was no longer mowing hay for which he had been hired and was involved in a purely gratuitous activity.<sup>46</sup>

In *Huntington Mutual Insurance Co. v. Walker*,<sup>47</sup> the insured farmer's policy excluded coverage for employees injured as a result of the insured's negligence. A tree trimmer working on the insured's farm was injured when the insured moved a tree limb with a tractor.<sup>48</sup> The insurance company pleaded the employee exclusion. The court, however, found the term "employee" to be ambiguous.<sup>49</sup> The court also found the tree trimmer to be a "casual" employee who was not excluded under the policy.<sup>50</sup>

#### *b. Inclusion of employees*

An employers' liability and employees' medical payments endorsement can be added to an FCLP to provide farm employers liability coverage. The endorsement covers the insured for liabilities arising out of a farm employee's injury. For there to be coverage three conditions concerning the injury must be met:

(1) it must be caused by an occurrence; (2) it must be sustained by a "farm employee"; (3) it must arise out of and in the course of the employee's employment in duties relating to the ownership, maintenance, or use of the "insured location" owned or operated for "arming purposes."<sup>51</sup>

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44. See, e.g., *Finegan v. Lumbermens Mut. Casualty Co.*, 329 F.2d 231 (D.C. Cir. 1963) (a farm employee injured during course of employment was not covered under the farmer's FCLP because the policy excluded injuries to employees, unless specifically declared in the policy, and the farmer failed to declare the employee). See also *Farmers Home Mut. Ins. Co. v. Lill*, 332 N.W.2d 635 (Minn. 1983) (employee injured in baling accident not covered because no premium charge had been made for farm employee).

45. 297 Minn. 522, 211 N.W.2d 517 (1973).

46. *Id.* at 523-24, 211 N.W.2d at 518.

47. 181 Ind. App. 617, 392 N.E.2d 1182 (1979).

48. *Id.* at 620, 392 N.E.2d at 1184.

49. *Id.* at 621, 392 N.E.2d at 1185.

50. *Id.*

51. FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Apf-1.

The bodily injury need not occur on the insured location. If employment duties take the farm employee off the location and the employee is injured, coverage still exists.<sup>52</sup>

The issue that most often arises with respect to farm employers' liability is whether the injured party is truly an employee. Even if the policy covers injuries to employees, a number of exclusions restrict or eliminate the coverage. For example, coverage does not apply to liabilities arising out of injuries to a farm employee if the injuries are in the scope of workers' compensation, disability benefits, unemployment compensation, or any similar laws.<sup>53</sup>

Other exclusions that apply to farm employer's liability coverage include:

(1) any contractually arranged obligations; (2) any claims or suits against the insured brought more than 36 months after the end of the policy period; (3) an employee's operation or maintenance of aircraft if it is designed to carry people or cargo; (4) injury to an illegally employed person, if the insured has knowledge of the illegal employment; (5) punitive damages for injury to any employee employed in violation of law; and (6) consequential damages sought by the spouse, child, parent or sibling of an injured "farm employee."<sup>54</sup>

3. *Medical Payments for Employees.*—In addition to providing compensation for bodily injury, the employers' liability and employees' medical payments endorsement also covers medical payments for employees. Expenses, however, must be incurred or ascertained within three years of the date of the accident causing the bodily injury. Reasonable medical expenses include first aid, medical, surgical, X-ray, and dental services; prosthetic devices; and ambulance, hospital, professional nursing, and funeral services. Payments under the policy are excluded, however, if the insured voluntarily provides or is required to provide benefits

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52. *Id.*

53. See *Oregon Farm Bureau v. Thompson*, 235 Or. 162, 378 P.2d 563, *reh'g denied*, 235 Or. 176, 384 P.2d 182 (1963); *Bakel v. Colorado Farm Bureau Mut. Ins. Co.*, 512 P.2d 285 (Colo. App. 1973).

54. FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Apf-2. See *Tisdale v. Hasslinger*, 79 Wis. 2d 194, 255 N.W.2d 314 (1977) (an 11 year old, injured while operating a hay baler on the insured's farm, was not covered as an employee because state law specifically forbade anyone under 16 years of age from operating farm tractors or self-propelled vehicles). See also *Farm Bureau Ins. Co. v. Pedlow*, 3 Mich. App. 478, 142 N.W.2d 877 (1966) (15-year-old boy injured while operating a defective manure spreader was not an employee because state statute prohibited any person under age 18 from cleaning moving machinery or being employed in any hazardous job).

under any workers' compensation, disability benefits, or unemployment compensation law, or any similar law.<sup>55</sup>

Many of the FCLPs, however, exclude medical payments for farm employees unless such coverage is specifically added. They also exclude coverage for any "other persons" engaged in work "incidental to the maintenance or use of the premises as a farm."<sup>56</sup> This exclusion does not apply, however, to persons injured on the property while involved in a neighborly exchange of assistance for which the insured is not obligated to pay any money. For there to be medical coverage for a neighbor injured while assisting a farmer, the situation must be a typical neighborly exchange with the insured performing services in return. Furthermore, there must be no obligation on the part of the insured to pay money for the help. This feature applies only to injuries that happen on the insured's premises.<sup>57</sup>

#### IV. FARMING ACTIVITIES AND THE BUSINESS PURSUITS EXCLUSION

The farmer's comprehensive liability policy provides coverage for bodily injuries and property damage arising out of farming activities, and excludes from coverage business pursuits other than farming. The following is typical of the farming definition and business pursuits exclusion found in the FCLPs.

This coverage does not apply

to *bodily injury or property damage* arising out of (1) business pursuits of any *insured* except (i) activities therein which are ordinarily incident to non-business pursuits and (ii) *farming*, or (2) the rendering of or failing to render professional services.<sup>58</sup>

##### A. *Definition of Farming*

Although the standard FCLP provides coverage only for farming activities, farming is rarely defined within the policy. As a result, the courts often have been left to define the term. In attempting to define farming, the courts have relied have upon a variety of sources, including Webster's Dictionary, various law dictionaries, agricultural zoning cases, and tax cases involving the preferential treatment of agricultural lands.<sup>59</sup>

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55. FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Apf-2.

56. *Id.* at Farms Apf-9.

57. *Id.*

58. Clause taken from Fireman's Fund Insurance Companies FCLP § I. Coverage L-Personal Liability, Exclusions Cb (emphasis added). *See also* FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Ap-5.

59. *See* Aetna Casualty Ins. Co. v. Brethren Mut. Ins. Co., 38 Md. App. 197, 379 A.2d 1234 (1977).

The courts have defined farming broadly to include all acts and products connected with the tillage of soil and agricultural husbandry.

The courts frequently have had difficulty determining what constitutes a farming activity, an activity incidental to farming, or a separate business pursuit not covered under the terms of the policy. In *Bloss v. Rural Mutual Casualty Insurance Co.*,<sup>60</sup> the court had to determine whether raising mink constituted a farming activity. An employee sustained injuries while tending to the insured's minks. The employee also performed traditional farm duties. The court held that the mink raising operation was not a farming activity covered under the employer's FCLP.<sup>61</sup>

The confusion as to what constitutes farming is further exacerbated because the standard FCLP does not clearly define what constitutes an uninsured business pursuit. Such policies typically define a business as any "trade, profession or occupation, other than farming and roadside stands maintained principally for the sale of the insured's produce."<sup>62</sup>

The failure to define farming clearly, or to delineate within the policy what constitutes a noninsured business activity, is even more problematic given that many farmers supplement their farm income with other fee-generating activities. Those fee-generating activities that are derived from the use of the land for something other than traditional farming activities can be especially troubling. For example, farmers occasionally lease their land to others for hunting and fishing purposes. A number of economic studies recommended that landowners supplement their farm income with earnings from recreational activities on their land.<sup>63</sup> But when such activities occur, the question arises as to whether the farmer is protected under the FCLP from the liability claims of persons who might be injured during those activities.

In determining whether an activity constitutes a business pursuit not covered under the FCLP, the courts traditionally have used a two-pronged test. The courts look to see if there is 1) a profit motive, and 2) evidence of continuity in the activity. If both elements are present, the courts invariably have found that the landowner's activity constitutes a business pursuit, separate and apart from farming, and any cause of action arising out of the activity is not covered under the farm owner's liability policy.

For example, in *Heggen v. Mountain West Farm Bureau Mutual Insurance Co.*,<sup>64</sup> the court found that both prongs of the business pursuit

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60. 270 Wis. 127, 70 N.W.2d 602 (1955).

61. *Id.* at 130, 70 N.W.2d at 604-05.

62. See *Martin v. Shepard*, 134 Vt. 491, 493, 365 A.2d 971, 973 (1976).

63. See, e.g., CONFERENCE PROCEEDINGS: INCOME OPPORTUNITIES FOR THE PRIVATE LANDOWNER THROUGH MANAGEMENT OF NATURAL RESOURCES AND RECREATIONAL ACCESS, West Virginia University Extension Service, Rural Development Publication No. 740 (1990).

64. 220 Mont. 398, 715 P.2d 1060 (1986).

test were met when the insured staged an annual steer roping contest on his ranch. Although the annual fees charged to the participants only totalled between \$1,200 to \$1,500, and the fees were distributed as prize money, the court still found a profit motive.<sup>65</sup> The court also found that the steer roping events were regular and continuous, even though in some years several were held and in other years only one was held. As a result, the business exclusion applied and there was no coverage under the insured's FCLP when a participant was injured.<sup>66</sup>

The court in *Aetna Casualty & Security Co. v. Brethren Mutual Insurance Co.* found that the insurer's failure to define the term "farming" created an ambiguity.<sup>67</sup> The insureds were involved in the raising, training, and pasturing of thoroughbred race horses. The insurance coverage issue arose when the insureds' horses escaped and were involved in an automobile collision. The insurer claimed that the insureds' activities constituted a business pursuit excluded from the FCLP coverage.<sup>68</sup> The court, however, held that although the pasturing of horses for a fee normally would be regarded as a business pursuit, the raising and grazing of animals constituted farming.<sup>69</sup> Although some of the insureds' activities, such as the breeding, training, and selling of horses and the activities incident thereto, could be characterized as a business, other activities, such as the grazing and raising of horses could be characterized as farming.<sup>70</sup>

Cases involving off-the-farm activities have presented the courts with fewer difficulties. A court had little difficulty in finding that a farmer who also worked as a school teacher was not covered under his FCLP for the alleged physical abuse of a student occurring at the school.<sup>71</sup> A court also dismissed the coverage claim of a farmer who also worked as a locomotive engineer for injuries arising out of the insured's negligent operation of the locomotive and subsequent accident.<sup>72</sup>

A more difficult case, however, was *White v. State Farm Mutual Automobile Insurance Co.*<sup>73</sup> The insured obtained a comprehensive policy

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65. *Id.* at 1062-63.

66. *Id.* at 1063. *But see Randolph v. Ackerson*, 108 Mich. App. 746, 310 N.W.2d 865 (1981) (using the two-pronged test, the court found that the insured, who tore down an old barn and sold the wood for a profit, was not engaged in business pursuit within the policy exclusion, because there was no evidence he regularly razed barns for profit).

67. 38 Md. App. 197, 205, 379 A.2d 1234, 1238 (1977).

68. *Id.* at 208, 379 A.2d at 1236.

69. *Id.* at 213, 379 A.2d at 1243.

70. *Id.* at 213, 379 A.2d at 1242-43.

71. *Reliance Ins. Co. v. Fisher*, 164 Mont. 278, 521 P.2d 193 (1974).

72. *Transamerica Ins. Co. v. Preston*, 30 Wash. App. 101, 632 P.2d 900 (1981).

73. 59 Tenn. App. 707, 443 S.W.2d 661 (1969).

to cover his farming operations. In addition to his farming activities, the insured was also a partner in a bulldozer operation.<sup>74</sup>

The insured rented farm land from a property owner who hired the insured's bulldozer operation to clear the land for cultivation. During the clearing process, an employee hired by the insured was injured while burning piles of brush.<sup>75</sup> The insured's FCLP provided coverage for injured employees. The insurer, however, refused coverage because the injured employee worked for the bulldozer operation at the time of the accident and not for the insured as a farm employee and because the policy contained a business pursuits exclusion.<sup>76</sup>

The court agreed with the insurance company and held that at the time of the accident the employee worked for the bulldozer company, even though the insured would farm the cleared land. Because the employee was employed by the insured's other business pursuit and not employed as a farm laborer, there was no coverage under the FCLP.<sup>77</sup>

#### *B. Exemption for Activities Ordinarily Incident to Nonbusiness Pursuits*

The standard FCLP does exempt from the business pursuits exclusion those activities ordinarily incident to nonbusiness pursuits. Certain activities are exempt from the business pursuits exclusion even though they are profit motivated and have continuity because they are incidental to the farming operation. The classic example of an exempt activity is the operation of a roadside stand to sell the farmer's produce. If a customer is injured at the stand as a result of the farmer's negligence, the event would be covered under the farmer's FCLP. Some policies now make a specific reference to the roadside stand exception.

Under the incidental to farming exception, coverage under FCLPs has been found in a variety of situations. For example, in one case a farmer received a monthly state allotment as a foster parent for agreeing to care for children temporarily.<sup>78</sup> The farmer occasionally permitted the foster children to feed the cattle. Although the children considered farm chores to be pleasure rather than work and the farmer received state aid as a foster parent, the court still found that coverage under the farmer's comprehensive liability insurance policy existed when one of the foster children was injured while cutting the binding on a bale of

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74. *Id.* at 715, 443 S.W.2d at 664.

75. *Id.*

76. *Id.* at 719, 443 S.W.2d at 666-67.

77. *Id.* at 722, 443 S.W.2d at 668-69.

78. *Country Mut. Ins. Co. v. Watson*, 1 Ill. App. 3d 667, 669-70, 274 N.E.2d 136, 138 (1971).

hay.<sup>79</sup> The court held the child's activity to be an ordinary incident to normal farming operations.<sup>80</sup>

Occasionally, courts have stretched the concept of what constitutes an activity incidental to farming to find coverage. For example, in *Wint v. Fidelity & Casualty Co. of New York*,<sup>81</sup> the insured's operation consisted of a riding stable and pasturing other people's horses for a fee. Several of the pastured horses escaped onto a public highway. One of the horses collided with a vehicle and the driver of the vehicle was killed.<sup>82</sup>

One of the issues in the case was whether the event was covered under an FCLP.<sup>83</sup> While conceding that a "riding club" venture might be beyond a reasonable interpretation of "farming," the court held that a broad definition could include the grazing of animals.<sup>84</sup>

The court added that even if "grazing for hire" activities were a nonfarming pursuit, coverage under the FCLP still existed.<sup>85</sup> The court found that keeping fences and gates repaired, as well as closed, is ordinarily incident to normal farming activities. Because the injuries arose from a failure to keep the gates closed, there was coverage under the FCLP.<sup>86</sup>

### C. Custom Farming

Custom farming is also excluded under the standard FCLP unless the landowner pays a separate premium for the coverage. FCLPs typically contain the following language as to custom farming:

This policy does not apply

under any coverage for injury, death or destruction arising out of custom farming operations unless such coverage is designated in the declarations and a premium paid therefor; . . .<sup>87</sup>

Custom farming is defined as "the use of any tractor, farm implement or farm machinery for farming purposes for others for a charge, including the maintenance, movement, or transportation of any tractor, farm implement or farm machinery in connection therewith and incidental thereto."<sup>88</sup>

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79. *Id.*

80. *Id.*

81. 9 Cal. 3d 257, 507 P.2d 1383, 107 Cal. Rptr. 175 (1973).

82. *Id.* at 260, 507 P.2d at 1385-86, 107 Cal. Rptr. at 177.

83. *Id.* at 260-62, 507 P.2d at 1386, 107 Cal. Rptr. at 177-78.

84. *Id.* at 262-63, 507 P.2d at 1387, 107 Cal. Rptr. at 178-79.

85. *Id.* at 263, 507 P.2d at 1387, 107 Cal. Rptr. at 179.

86. *Id.*

87. Shelter Mutual Insurance Company's FCLP, § Exclusions (f).

88. *Id.* at IV Other Definitions (g).

Some FCLPs provide coverage for custom farming activities if the receipts from the activity over a particular period do not exceed a specified dollar amount. The following is typical of such provisions: "But this exclusion will apply only when your receipts during the 12 months immediately preceding the date of the 'occurrence' from such operations exceed \$2,000."<sup>89</sup>

A number of courts have determined that the custom farming exclusion applies to the actual activity of custom farming and not necessarily to the activities preparatory to custom farming. Thus, on a number of occasions coverage has been found under an FCLP even though the insured clearly was about to engage in custom farming. For example, the custom farming exclusion did not preclude recovery when a collision occurred between the insured's tractor and the plaintiff's car while the insured farmer was towing a hay baler from one custom farming job to another.<sup>90</sup>

## V. INSURED PREMISES

### A. *Described Premises*

The basic FCLP extends coverage to liability arising from the ownership, use, or maintenance of the "farm premises."<sup>91</sup> FCLPs specifically describe the insured farm premises. The description is normally set out on the policy's declarations page. Generally, bodily injury or property damage occurring away from the described farm premises is not covered. The farm premises is the location identified in the declarations page and operated for farming purposes. The structures used as residences, garages, stables, and individual or family cemetery plots are included within the definition.<sup>92</sup>

If a structure is located on the insured premises, it may be covered under the FCLP even if its primary use is not farm related. In *Daire v. Southern Farm Bureau Casualty Insurance Co.*,<sup>93</sup> an accident occurring at a fishing camp located on the insured's farm was found to be within the FCLP because the camp was frequently used by the farm hands for cooking and other purposes. The court found that the use of a building in connection with a farming operation meant that its use had only to

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89. ISO, FL-00-20-10-88, *supra* note 11, Coverage H-Bodily Injury and Property Damage Liability, § 2i. See also FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Ap-5.

90. See *United Fire and Casualty Co. v. Mras*, 243 Iowa 1342, 55 N.W.2d 180 (1952).

91. FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Ap-2, 3.

92. *Id.*

93. 143 So. 2d 389 (La. 1962) (superseded by statute as stated in *Holder v. Louisiana Partes Service*, 555 So. 2d 20 (La. App. 1989), *cert. denied*, 556 So. 2d 59 (La. 1990)).

be related to, or associated with, the ownership of the farm operation.<sup>94</sup>

### B. Undescribed Premises

The FCLP excludes from coverage any liability arising out of premises owned, rented, or controlled by the insured if those premises are not listed in the policy declaration. In *Dorre v. Country Mutual Insurance Co.*,<sup>95</sup> the insured declared his 309-acre grain farm. The insured did not list an adjoining twelve-acre tract owned by his son. When a tenant was injured on the son's tract, the court held that there was no coverage under the father's policy even though the father helped his son farm the adjoining tract.<sup>96</sup>

However, in a similar case, *Industrial Fire & Casualty Insurance Co v. Grinnell Mutual Reinsurance Co.*,<sup>97</sup> the court found coverage under a father's FCLP. The policy's premises description included not only the insured's premises as listed on the declarations page, but also other premises owned, operated, or rented by the insured. The insured father and his son jointly owned cattle on the son's adjacent farm. The cattle were tended by the son under an agreement with his father. When some of the cattle escaped onto a public highway and caused an accident, the father's policy covered the damages. The son's farm constituted "other premises" used in connection with the father's insured premises.<sup>98</sup>

### C. Ways Adjoining and Adjacent to the Described Premises

FCLPs frequently provide that the coverage on premises also includes the ways adjoining and adjacent to the premises described on the declarations page. The terms "ways adjoining" and "adjacent thereto" are relative, and can only be determined by the context in which they are used and by the facts and circumstances surrounding each dispute. The interpretation of these terms has led to frequent litigation.

In *Farm Bureau Mutual Insurance Co. v. Sandbulte*,<sup>99</sup> the insured's farm owner's liability policy provided coverage for motor vehicles on the insured premises or "ways immediately adjoining" the premises. The insureds were involved in an accident while driving a pickup truck on a public highway between parcels of land that were owned by the insured and that were covered as insured premises under the FCLP. The insurance company refused to provide a defense or accept coverage because the

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94. *Id.* at 391.

95. 48 Ill. App. 3d 880, 363 N.E.2d 464 (1977).

96. *Id.* at 882, 363 N.E.2d at 466.

97. 100 Ill. App. 3d 593, 427 N.E.2d 431 (1981).

98. *Id.* at 597, 427 N.E.2d at 434.

99. 302 N.W.2d 104 (Iowa 1981).

policy excluded coverage for motor vehicles "while away from the insured premises or the ways immediately adjoining."<sup>100</sup> The court agreed with the insurance company. The court held the phrase "ways immediately adjoining" to be unambiguous and to mean that the "way" upon which the incident occurs must touch or abut the insured premises at the point of occurrence.<sup>101</sup>

#### *D. Away From Premises Exclusion*

FCLPs routinely exclude from coverage bodily injuries or property damage from the use of automobiles or other mechanical devices, such as snowmobiles, "away from the premises." The exclusion applies to the ownership, maintenance, operation, use, loading, or unloading of such equipment if the bodily injury or property damage occurs away from the insured premises. For example, in *Stover v. State Farm Mutual Insurance Co.*,<sup>102</sup> the insured's farm owner's liability policy did not cover the insured's employee in a fall from the insured's truck while the employee was loading shelled corn onto the truck at a farm owned by a third party.

Insureds have attempted to circumvent the exclusion by asking courts to focus on the situs of the act of negligence instead of the location of the actual accident. The argument is that although the accident may have occurred away from the insured premises, the act of negligence that caused the accident took place on the farm premises. In *Scherschligt v. Empire Fire & Marine Insurance Co.*,<sup>103</sup> the insured negligently constructed a trailer hitch on farm equipment used in his farming operation.<sup>104</sup> The hitch broke while the insured was towing an old pickup truck on a public highway. The resulting accident severely injured the driver of another vehicle. The insurance company denied coverage because the action arose out of the insured's use of an automobile away from the insured farm premises.<sup>105</sup> In holding for the insurance company, the court emphasized the location of the loss rather than the negligence that precipitated it.<sup>106</sup>

The court reached a similar result in *Bankert v. Threshermen's Mutual Insurance Co.*<sup>107</sup> The insureds entrusted their minor son with an unlicensed motor vehicle. The act of entrustment took place on the farm premises.

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100. *Id.* at 107.

101. *Id.* at 108.

102. 189 N.W.2d 588 (Iowa 1971).

103. 662 F.2d 470 (8th Cir. 1981) (applying Neb. law).

104. *Id.* at 471.

105. *Id.*

106. *Id.* at 473.

107. 110 Wis. 2d 469, 329 N.W.2d 150 (1983).

The son drove the vehicle off the premises and was involved in an accident that severely injured another person. The court upheld the insurance company's position that there was no coverage under the FCLP.<sup>108</sup> Although the negligent entrustment occurred on the farm premises, the accident took place away from the premises.<sup>109</sup>

## VI. POLLUTION COVERAGE

Farmers are concerned about whether their FCLP, provide coverage for pollution. The liability claims that can arise out of polluting events are extensive and varied. Besides the traditional claims of personal injury, property damage, and business interruption, there are also unique claims such as "inverse condemnation," natural resource deprivation, medical surveillance, emotional distress, [and] environmental cleanup."<sup>110</sup>

Pollution cases also have some unique characteristics that are particularly perplexing to insurance companies and their insureds. Some of the characteristics include the following:

1. The amounts claimed are often indeterminate and frequently substantial;
2. Claims are often made as to exposures, conduct, or circumstances that occurred years before the claims are actually made. As a result, information concerning the events are often difficult to recreate;
3. Pollution claims extend over long periods of time in which there may have been many changes to the extent of insurance carried by the accused, as well as changes in insurers;
4. The relief request is often nontraditional. Relief may include not only payments of money, but also such nontraditional costs as medical surveillance or environmental cleanup.<sup>111</sup>

Traditionally, agriculture has not been subjected to environmental litigation to the extent of industrial and other commercial enterprises. Possibly the lack of litigation involving farms or ranches and agribusiness in general can be attributed to the public's rather benign view of agriculture. Factories pollute, not farms.

However, the public's perception of agriculture as a clean, non-polluting activity is rapidly changing. A recent poll indicated that over seventy percent of Americans feel that agriculture uses too many chem-

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108. *Id.* at 480, 329 N.W.2d at 154.

109. *Id.* at 481, 329 N.W.2d at 154-55.

110. M. DORE, *LAW OF TOXIC TORTS* 28-3 (1988).

111. *Id.* at 28-4.

icals.<sup>112</sup> There also have been a number of environmental studies that blame a large percentage of the nation's environmental problems on agriculture, especially ground water contamination.<sup>113</sup>

In light of a changing public perception of agriculture and increased scientific evidence that agriculture is a major polluter, it is only a matter of time before those involved in agriculture are subjected to an ever-increasing number of environmental lawsuits.

Just as farmers are finding an increasing need for pollution coverage, insurers are limiting the availability of coverage under the standard FCLP. To understand the present restrictions on pollution coverage within FCLPs, it is useful to trace the development of pollution coverage. Many of the pollution cases subsequently referred to are not agricultural cases. These cases involve the interpretation of commercial or comprehensive general liability insurance policies (CGLs) rather than FCLPs. However, the legal principles set forth are equally applicable to agricultural activities. The pollution coverage issues and policy language are virtually identical in CGLs and FCLPs.

#### *A. Accident-Based Policies*

Before 1966, comprehensive liability policies were "accident-based" policies that made the following promise on behalf of insurers:

To pay, on behalf of the insured, all funds which the insured shall become legally obligated to pay as damages because of bodily injury, sickness or disease . . . sustained by any person, or because of any injury to or destruction of property . . . caused by an accident.<sup>114</sup>

The term accident implies an event rather sudden in nature.<sup>115</sup> Certainly, insurers intended that coverage was available only as to those events that were "sudden, violent, catastrophic and specific."<sup>116</sup> However, the policies' failure to define the term "accident" naturally created some confusion and concern in the courts. One court even expressed "wonderment" over the failure of insurers to define the term.<sup>117</sup>

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112. National Farm Finance News, Aug. 3, 1990, at 10, col. 1.

113. See EPA, REPORT TO CONGRESS: NONPOINT SOURCE POLLUTION IN THE U.S. 2-6-2-13 (1984); EPA, NATIONAL WATER QUALITY INVENTORY, 1988 REPORT TO CONGRESS 7-10, 22-25, 121-26.

114. M. DORE, *supra* note 110, at 28-11-28-12.

115. FC&S BULLETINS, *supra* note 26, Nov. 1987, at Public Liability Cop-1.

116. Farnow, Inc. v. Aetna Ins. Co., 33 Misc. 2d 480, 483, 227 N.Y.S.2d 634, 638 (Sup. Ct. 1962).

117. See White v. Smith, 440 S.W.2d 497, 511 (Mo. Ct. App. 1969).

1. *Interpretation Problems in General.*—Some courts held that the "plain meaning" of the term "accident" excludes coverage for situations that do not involve "the happening of a single event referable to [a] definite time and place."<sup>118</sup> Other courts, however, permitted coverage for situations in which the events giving rise to liability transpired over a period of time, recognizing that "damage caused by a glacier is every bit as accidental as that caused by an avalanche."<sup>119</sup> Instead of focusing on the amount of time involved, the courts focused on whether the results were intentional.<sup>120</sup>

Questions also arose as to when an accident actually occurred. Did an accident take place when the event occurred or when the injury was manifested? Most courts have determined that coverage is triggered when the injury was suffered rather than when the conduct giving rise to the injury took place.<sup>121</sup> Also at issue was the perspective from which the accident should be viewed. Was the existence of an accident determined from the standpoint of the victim or the insured? From the victim's standpoint, there was almost always an accident. However, if viewed from the standpoint of the insured, there may or may not have been an accident. The courts generally have viewed the event from the standpoint of the insured.<sup>122</sup>

Some courts held that coverage did not extend to foreseeable damage because the damage was the natural and probable consequence of the insured's negligent conduct. It was not necessary that the actual result was foreseeable, but simply that the result was a natural and probable consequence of the activity.<sup>123</sup>

2. *Pollution Cases.*—In pollution cases, the concept of foreseeability frequently has been applied in interpreting "accident-based" policies. For example, coverage was denied with respect to contamination caused by sewage lagoons because the court determined that the insured took a calculated risk that pollution might occur.<sup>124</sup>

Other courts, however, rejected foreseeability tests in pollution cases. If the actual injury was not intended, the injury, by definition, was caused by an accident, regardless of the circumstance giving rise to the injury and the negligent conduct of the insured.<sup>125</sup>

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118. See M. DORE, *supra* note 110, at 28-19.

119. *Id.* at 28-20.

120. *Id.*

121. *Id.*

122. *Id.* at 28-21.

123. *Id.* at 28-21 to -22.

124. See *Town of Tieton v. General Ins. Co. of America*, 61 Wash. 2d 716, 380 P.2d 127 (1963); see also M. DORE, *supra* note 110, at 28-20 to -23.

125. See *Taylor v. Imperial Casualty and Indem. Co.*, 82 S.D. 298, 144 N.W.2d 856 (1966); see also M. DORE, *supra* note 110, at 28-20 to -23.

*City of Kimball v. St. Paul Fire & Marine Insurance Co.*<sup>126</sup> illustrates the divided authority on the concept of foreseeability. This case concerned coverage for the seepage of the waste from a municipality sewage lagoon. The majority held that the city's failure to discover the migration of waste from the sewage system resulted in damage that was unexpected and accidental.<sup>127</sup> However, the dissent determined that storage of waste materials in an unfilled lagoon was so likely to result in migration of waste that the coverage should not be permitted.<sup>128</sup>

### B. Occurrence-Based Policies

Confusion over defining the term "accident," as well as demands for increased coverage, led to the 1966 revision in which accident-based policies were changed to "occurrence-based" policies. The duty-to-pay clause was changed to read as follows: "The company will pay on behalf of the insured all sums which the insured shall become legally liable to pay as damages because of bodily injury or property damage . . . caused by an occurrence."<sup>129</sup> Occurrence was defined in such policies as "an accident, including injurious exposure to conditions, which result, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured."<sup>130</sup>

In 1973, the occurrence language was changed to read as follows: "[A]n accident, *including continuous or repeated* exposure to conditions, which results, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured."<sup>131</sup>

Although occurrence was defined, the term accident was still left undefined in such policies. The use of occurrence language clarified to some extent issues that arose under the accident-based policies:

1. While coverage still attached when bodily injury resulted during the policy period, it was now clear that the injury-producing incident could occur over an extended period of time, and did not have to be a single catastrophic event.<sup>132</sup>
2. Because an occurrence was defined as damage or injury "neither expected nor intended from the standpoint of the

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126. 190 Neb. 152, 206 N.W.2d 632 (1973).

127. *Id.* at 161-62, 206 N.W.2d at 638.

128. *Id.* at 162-69, 206 N.W.2d at 638-41 (White, C.J., and Boslaugh, J., dissenting). See also M. DORE, *supra* note 110, at 28-22.

129. M. DORE, *supra* note 110, at 28-23.

130. *Id.*

131. *Id.* at 28-24 (emphasis added).

132. *Id.*

insured," it was clear that unintended results of intentional acts frequently were covered under the standard liability policy.<sup>133</sup>

3. The issue of whether an occurrence had taken place which was neither expected nor intended was to be viewed from the standpoint of the insured.<sup>134</sup>

Although a number of problem areas were resolved under the new language, interpretation problems still existed. All too frequently from the standpoint of the insurers, these interpretation problems were resolved in favor of the insureds. A number of courts took the position that the definition of an "occurrence" was broader than the term "accident," and therefore "occurrence-based" policies substantially expanded insurance coverage.

The leading case that expanded coverage was *Grand River Lime Co. v. Ohio Casualty Insurance Co.*<sup>135</sup> This case involved extensive air pollution from a quarry and manufacturing site that caused damage to cars and homes in a nearby village. The insurer denied coverage and responsibility for the duty to defend because the damages resulted from seven years of pollution and because the results were to be "expected or intended."<sup>136</sup>

The court, however, held the term "occurrence" to be broader than the term "accident."<sup>137</sup> Although accidents happen in a certain way, occurrences happen or come about in any way. Furthermore, even though Grand River Lime intended to pollute, it did not intend to harm people or property. As a result, the insurer had to provide a defense and coverage.<sup>138</sup>

Other courts also adopted the position that the occurrence definition was broader than the term accident, and the coverage could be found for intentional acts if the resulting damage was not intended or expected. For example, in *Steyer v. Westvaco Corp.*,<sup>139</sup> Christmas tree farmers sued a neighboring insured paper mill for exposing the trees to pollution. The pollution occurred over a four-year period. The court found an "occurrence" because the injury was not expected or intended.<sup>140</sup>

The same result was reached in *United States Fidelity & Guaranty Co. v. Armstrong*.<sup>141</sup> Raw sewage dumped onto neighboring property

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133. *Id.*

134. *Id.* at 28-25.

135. 32 Ohio App. 2d 178, 289 N.E.2d 360 (1972).

136. *Id.* at 180-83, 289 N.E.2d at 362-64.

137. *Id.* at 184, 289 N.E.2d at 365.

138. *Id.* at 185, 289 N.E.2d at 365.

139. 450 F. Supp. 384 (D. Md. 1978).

140. *Id.* at 390.

141. 479 So. 2d 1164 (Ala. 1985).

was covered because even if the damage was foreseeable, it still was not expected or intended from the standpoint of the insured.<sup>142</sup>

### *C. Creation of the Pollution Exclusion*

The court decisions finding pollution coverage under the "occurrence-based" liability policy naturally alarmed the insurance industry. The industry became even more alarmed as tough environmental laws were enacted in the early 1970s and a series of massive environmental disasters took place, such as the sinking of the oil tanker *Torrey Canyon*.<sup>143</sup> As a result, the industry created the first pollution exclusion clause that was added to liability policies in 1973.

This insurance does not apply

to bodily injury or property damage arising out of the discharge, dispersal, release or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants, or pollutants into or upon land, the atmosphere or any water course or body of water; but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental.<sup>144</sup>

In drafting the 1973 pollution exclusion clause, the insurance industry steadfastly maintained that the "occurrence-based" policies already excluded from coverage most acts of pollution. Industry leaders contended that the new exclusion was meant only to clarify the existing exclusion:

Coverage for pollution or contamination is not provided in most cases under present policies because the damages can be said to be expected or intended and thus are excluded by the definition of occurrence. The [pollution] exclusion clarifies this situation so as to avoid any questions of intent. Coverage is continued for pollution or contamination caused by injuries where the pollution or contamination results from an accident.<sup>145</sup>

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142. See also *Benedictine Sisters v. St. Paul Fire & Marine*, 815 F.2d 1209 (8th Cir. 1987); *Pepper's Steel & Alloy v. United States & Guar. Co.*, 668 F. Supp. 1541 (S.D. Fla. 1987); *Buckeye Union Ins. Co. v. Liberty Solvents & Chem. Co.*, 17 Ohio App. 3d 127, 477 N.E.2d 1227 (1984). But see *American Mut. Liab. Ins. Co. v. Neville Chem. Co.*, 650 F. Supp. 929 (W.D. Pa. 1987) (in which groundwater contamination from uncorrected disposal problems at a dump site, after notification, was outside the definition of an occurrence as the additional damage was to be expected).

143. Comment, *Pollution Exclusion Clauses: The Agony, The Ecstasy, and the Irony For Insurance Companies*, 17 N. Ky. L. Rev. 443, 449 (1990).

144. *Id.* at 449 (citing M. RHODES, COUCH ON INSURANCE 2D § 1.172 (1984)).

145. Joest, *Will Insurance Companies Clean the Augean Stables - Insurance Coverage for the Landfill Operator*, Ins. Coun. J. 258, 259 (Apr. 1983).

However, the exclusion actually goes one step beyond the "occurrence" definition because damage arising out of the discharge, dispersal, release, or escape of pollutants is not insured, regardless of the insured's expectations or intentions. The only exception is for those polluting events that are sudden and accidental.<sup>146</sup>

1. *Court Decisions Invalidating the Exclusion.*—Although the insurance industry believed it solved its pollution coverage problems, a long series of court decisions demonstrated otherwise. The validity of the exclusion was ruled on first in *Molton, Allen & Williams, Inc. v. St. Paul Fire & Marine Insurance Co.*<sup>147</sup> The court declared the clause to be ambiguous and refused to deny coverage for pollution caused by the dispersal of sand and dirt during construction of a subdivision.<sup>148</sup>

*Niagra County v. Utica Mutual Insurance Co.*<sup>149</sup> was especially damaging to insurers. The case involved litigation that arose over Love Canal. In determining the insurer's duty to defend, the court held that the exclusion clause applied only to "active polluters."<sup>150</sup> The court also focused on whether the harm from the event was sudden and accidental, as opposed to whether the release of chemicals was sudden and accidental.<sup>151</sup> The court found that from the county's viewpoint, the pollution was sudden and accidental because it did not occur until the deleterious effects of the buried industrial toxic chemicals were discovered.<sup>152</sup>

From 1981 through 1987, insurers won only eight out of thirty-five cases interpreting the 1973 pollution exclusion.<sup>153</sup> Not only did a number of courts find the pollution clause to be ambiguous, one court declared the clause to be superfluous. The court held that the clause was nothing more than another way to define an "occurrence."<sup>154</sup>

2. *Waste Management Decision.*—By 1986, the insurance industry began to prevail in some of the cases interpreting the 1973 pollution exclusion. The true turning point, however, was *Waste Management of Carolinas, Inc. v. Peerless Insurance Co.*<sup>155</sup> The case involved a hazardous waste landfill that leaked into and contaminated a groundwater supply.

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146. FC&S BULLETINS, *supra* note 26, Nov. 1987, at Public Liability Cop-2.

147. 347 So. 2d 95 (Ala. 1977).

148. *Id.*

149. 103 Misc. 2d 814, 427 N.Y.S.2d 171 (N.Y. Sup. Ct.), *aff'd*, 80 A.D.2d 415, 439 N.Y.S.2d 538 (1980).

150. *Id.* at 817, 427 N.Y.S.2d at 174.

151. *Id.* at 820, 427 N.Y.S.2d at 174-75.

152. *Id.* at 821, 427 N.Y.S.2d at 175-76.

153. See Comment, *supra* note 143, at 455 n.78 (listing of the decided cases).

154. See *Jackson Township Mun. Util. Auth. v. Hartford Accident and Indem. Co.*, 451 A.2d 990 (N.J. 1982).

155. 315 N.C. 688, 340 S.E.2d 374 (1986).

In construing the pollution exclusion in the insurance policy, the North Carolina Supreme Court found:

- (1) The clause was not ambiguous;
- (2) The focus of the exclusion is not upon the release, but upon the fact that it contaminates or pollutes;
- (3) Gradual seepage is not by definition, "sudden" or "accidental."<sup>156</sup>

Since *Waste Management*, the reasoning of which many courts have adopted, insurers have fared much better in the courts. At the very least, there seems to be a fairly equal split. From 1987 through October 1989, of the fifty-one reported pollution cases, twenty-eight were decided in favor of insurers.<sup>157</sup>

3. *Two Agricultural Cases*.—A couple of agricultural cases clearly demonstrate the two views on interpreting the pollution exclusion.<sup>158</sup> In *Farm Family Mutual Insurance Co. v. Bagley*, the insureds were hired to spray oat fields. Using a boom sprayer, the defendants released chemicals approximately eighteen inches off the ground. Unfortunately, the sprayed chemicals were carried to neighboring land, causing damage to vineyards and crops. The insured's policy contained the standard pollution exclusion.<sup>159</sup>

The key issue in the case was whether the spraying of the neighboring land was sudden and accidental. The court determined that something is accidental when it is "unexpected, unusual and unforeseen" from the standpoint of the insured.<sup>160</sup> Because the insured had used due care and diligence in spraying the oat fields, (no wind was present at the time the oat fields were sprayed), the dispersal of the chemicals onto the neighboring vineyards and crops was unexpected, unusual, and unforeseen from the standpoint of the insured. Thus, the pollution was sudden, accidental, and within the insured's FCLP coverage.<sup>161</sup>

In *Weber v. IMT Insurance Co.*,<sup>162</sup> the court interpreted two insurance policies with respect to an act of pollution. The insureds, the Webers, owned a modern farming operation that included raising hogs from farrow to finish. As part of their operation, they used a spreader to

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156. *Id.* at 695-700, 340 S.E.2d at 381-82; *see* Comment, *supra* note 143, at 459 (parenthetical explanation).

157. Comment, *supra* note 143, at 460 n.98.

158. *Farm Family Mut. Ins. Co. v. Bagley*, 64 A.D.2d 1014, 409 N.Y.S.2d 294 (1978).

159. *Id.* at 1014, 409 N.Y.S.2d at 295.

160. *Id.*

161. *Id.* at 1014, 409 N.Y.S.2d at 295-96.

162. No. 9-437-1389, slip op. (Iowa Ct. App. Apr. 24, 1990) (affirming declaratory judgment), *vacated*, 462 N.W.2d 283 (Iowa 1990).

transport manure down a gravel road. During hauling, the spreader sometimes dropped manure on the gravel road. This operation had been conducted for a number of years when the Weber's neighbors, the Newmans, filed an action seeking damages for the contamination of their corn crop and other property by fumes from the manure dropped or spread on the road. The Webers had two policies, a standard policy and an umbrella policy, with IMT. The Webers looked to IMT to defend them and to provide them with insurance coverage. However, IMT denied coverage.<sup>163</sup>

With regard to the first policy, IMT relied on language that stated that coverage was limited to accidents "neither expected nor intended from the standpoint of the insured" and that there was no coverage for the discharge of "waste materials" unless the discharge was "sudden and accidental." In a declaratory judgment for the insurance company, the court held the pollution exclusion to be unambiguous.<sup>164</sup> The court stated that the exclusion applied to waste materials, and that a reasonable interpretation of that would include hog manure.<sup>165</sup>

The court also agreed with the insurance company's contention that the insured's spilling and depositing of manure on the road was not sudden and accidental. Instead, the pollution and its consequences were a result of the Webers' regular and ongoing farming activities occurring over a ten- to fifteen-year period.<sup>166</sup> The Iowa court cited the Sixth Circuit ruling in *United States Fidelity & Guaranty Co. v. State Fire Co., Inc.*,<sup>167</sup> which held that such pollution clauses as found in the Webers' policy apply to the release of waste materials and pollutants taking place on a regular basis or in the ordinary course of business.<sup>168</sup>

With regard to the umbrella policy issued by IMT, the policy did not contain a pollution exclusion, but did contain the following definition of an occurrence: "[O]ccurrence means an accident, including continuous or repeated exposure to conditions, which result in bodily injury or property damage neither expected nor intended from the standpoint of the insured."<sup>169</sup> The court found that occurrence means an accident. Furthermore, for there to be coverage under the policy, the accident must result in damage that was neither expected nor intended. In determining whether an injury is expected or intended from the standpoint

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163. *Id.* at 3.

164. *Id.* at 4.

165. *Id.* at 4-6.

166. *Id.* at 6-8.

167. 856 F.2d 31 (6th Cir. 1988).

168. *Weber*, No. 9-437-1389, slip op. at 7.

169. *Id.* at 10.

of the insured, the test of substantial probability is to be used. Substantial probability is more than "reasonably foreseeable."<sup>170</sup> Applying the substantial-probability standard to the facts of *Weber*, the court concluded that the damages caused to the neighboring property were highly likely to occur.<sup>171</sup> As a result, there was also no coverage under the umbrella policy of insurance.<sup>172</sup>

On October 17, 1990, the Iowa Supreme Court vacated the court of appeals decision. The court affirmed in part and reversed in part the district court decision, and remanded the case.<sup>173</sup>

The Iowa Supreme Court affirmed the lower court's ruling that there was no coverage under the primary liability policy because of the pollution exclusion. The court agreed that the term "waste material" in the pollution exclusion was not ambiguous, even though the term was not defined in the policy. Giving the term its ordinary meaning, the court held that the term would encompass hog manure spilled on the road.<sup>174</sup> The court also agreed with the lower court ruling that there was nothing "sudden and accidental" about the spill.<sup>175</sup>

However, the Iowa Supreme Court differed from the lower court with respect to the umbrella policy. The court held that although the Webers were aware that they were spilling manure, there was no evidence that they intentionally contaminated the Newmans' sweet corn crop.<sup>176</sup>

As to whether the damage was expected, the court held that the evidence did not support the lower court's ruling that the Webers knew, or should have known, that the spilled manure would ruin the Newmans' sweet corn.<sup>177</sup> There was no evidence that the Newmans had previously complained to the Webers that the sweet corn crop was being ruined by the spilled manure, nor was there any testimony that the Webers knew damage was occurring. As a result, it could not be said that the Webers expected property damage to occur.<sup>178</sup>

#### *D. Absolute Exclusion*

A number of liability policies, especially those written after 1986, contain an absolute pollution exclusion. The following is typical of such exclusions:

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170. *Id.* at 11.

171. *Id.* at 12.

172. *Id.* at 12-13.

173. *Weber v. IMT Ins. Co.*, 462 N.W.2d 283 (Iowa 1990).

174. *Id.* at 285.

175. *Id.* at 286-87.

176. *Id.* at 288.

177. *Id.*

178. *Id.* at 289.

This coverage does not apply to:

- (1) "Bodily injury" or "property damage" arising out of the actual, alleged or threatened discharge, dispersal, release or escape of pollutants:
  - (a) At or from premises you own, rent, occupy or borrow;
  - (b) At or from any site or location used by or for you or others from the handling, storage, disposal, processing or treatment of waste;
  - (c) Which are at any time transported, handled, stored, treated, disposed of, or processed as waste by or for you or any person or organization for whom you may be legally responsible; or
  - (d) At or from any site or location on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations:
    - (i) If the pollutants are brought on or to the site or location in connection with such operations; or
    - (ii) If the operations are to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize the pollutants.<sup>179</sup>
- (2) Any loss, cost or expense arising out of any governmental direction or request that you test for, monitor, clean up, remove, contain, treat, detoxify or neutralize pollutants.<sup>180</sup>

Pollutants means any solid, liquid, gaseous, or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals, and waste. Waste includes materials to be recycled, reconditioned, or reclaimed.<sup>181</sup>

#### *E. Limited Coverage*

Because of the absolute exclusion, some farmers now are obtaining an endorsement to their FCLPs for limited farm pollution coverage. The limited coverage is obtained by means of an exception to item (1) of the pollution exclusion permitting coverage for "*bodily injury or property damage caused by or resulting from the discharge, dispersal, release or*

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179. FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms App-1.

180. *Id.*

181. *Id.*

*escape of smoke or farm chemicals, liquids or gases used or intended for use in normal and usual farming or agricultural operations.”<sup>182</sup>*

Obviously, this limited coverage does not protect the insured from lawsuits involving run-off animal wastes. Also, the coverage is subject to the following three conditions:

1. If “the discharge, dispersal, release or escape” occurs off the farm premises, it must be sudden and accidental and occur during transportation or storage;
2. The pollutant “must not have been released from an aircraft;”
3. The “agricultural operations must not be in violation of any ordinance or law.”<sup>183</sup>

## VII. A POTPOURRI OF OTHER EXCLUSIONS

Besides the exclusions already discussed, the standard FCLP contains a number of other exclusions that affect farmers and their activities. Many of these exclusions frequently catch unaware farmers.

### A. *Products Liability and Warranty Exclusions*

FCLPs usually contain products liability and warranty exclusions. Such exclusions typically read as follows:

This policy does not apply to

[a]ny occurrence arising out of the handling or use of, the existence of any condition in, or a warranty of, goods or products manufactured, produced, grown, sold, handled or distributed by the insured if the occurrence arises after the insured has relinquished possession thereof to others and away from premises owned, rented or controlled by the insured.<sup>184</sup>

This sort of exclusion, of course, has great significance to agricultural producers who find that their liability coverage ends the moment their product leaves the farm premises. Thus, if the product, such as produce, grain, or even baled hay, is sold to third parties and removed from the premises and the third party is injured by the product, there is no liability coverage under the FCLP.

Some insureds have attempted to avoid this exclusion by arguing that even though the third-party damage occurred off the farm premises,

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182. FC&S BULLETINS, *supra* note 26, Oct. 1987, at Farms Aplp-4 (emphasis in original).

183. *Id.*

184. *National Farmers Union Property & Casualty Co. v. Iverson*, 346 F. Supp. 660, 663 (D.S.D. 1972).

the negligent act occurred on the insured's premises and therefore should be covered under the policy. For example, in *National Farmers Union Property & Casualty Co. v. Iverson*,<sup>185</sup> the insured's business consisted of cutting, baling, and selling alfalfa hay. A dairy farm purchased some of the hay. The hay contained bits of metal that caused the dairy cattle to get hardware's disease. The insurance company for the alfalfa business refused to provide coverage because of the standard products liability exclusion found in the policy. The insured argued that the negligence took place on the premises, and even though the cattle were damaged off the premises, there was continuity between the act of negligence and subsequent injury.<sup>186</sup>

The court, however, held that the exclusion was applicable, and found that liability was established at the place where the injury occurred and not where the cause of action arose.<sup>187</sup> The court noted that in most cases where damages or injuries are caused by the handling or use of a defective product, the occurrence can be traced to some preexisting negligence.<sup>188</sup> To give controlling effect to the allegation of the preexisting negligence to determine at what point liability arose would emasculate the product liability exclusion.<sup>189</sup>

### *B. Care, Custody, or Control Exclusion*

The standard FCLP excludes coverage for property or persons in the care or custody and control of the insured. As a result of the exclusion, the insured is relieved from liability for bodily injuries or property damage sustained by such property or persons.

1. *Persons*.—The care, custody, or control exclusion for people is analogous to the family or household exclusion. For example, in *Goller v. White*,<sup>190</sup> the court found a twelve-year-old foster child to be a member of the insured's household; thus, the child's injuries were subject to the family exclusion. In addition, the care, custody, or control exclusion was applicable. The child had been placed in the insured's legal care for medical treatment and education, and the insured had a duty to control and discipline the child.<sup>191</sup>

2. *Property*.—Numerous cases discuss an exclusion for property damage. For example, in *Moore v. M.F.A. Mutual Insurance Co.*,<sup>192</sup>

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185. *Id.* at 663.

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.* at 664.

190. 20 Wis. 2d 402, 122 N.W.2d 193 (1963).

191. *Id.* at 407-09, 122 N.W.2d at 195-96.

192. 422 S.W.2d 357 (Mo. App. 1967).

the insured farmer operated a combine owned by a third party. An accident occurred while the insured operated the combine on a public highway. In affirming a summary judgment for the insurance company, the court held that the insured could not recover under the provisions of his FCLP because although he did not own the combine, it was in his care, custody, or control at the time of the accident and therefore came within the applicable exclusion.<sup>193</sup>

A less typical case, but one in which the exclusion also applied, is *A. H. Karpe v. Great American Indemnity Co.*<sup>194</sup> In *Karpe*, the insured raised registered herefords. A third party left a hereford cow with the insured to be bred at the insured's ranch. The insured mistook the third party's hereford cow for one of his own and sent the cow to the slaughter house.<sup>195</sup> The insured's carrier refused to acknowledge coverage because the animal was destroyed while in the care, custody, or control of the insured and because there was an applicable exclusion in the insured's policy. The insured argued that the event of liability — the death of the cow — actually occurred at the slaughter house.<sup>196</sup> The court rejected the insured's argument and found that the negligence occurred while the animal was under the insured's care, custody, or control.<sup>197</sup>

An example of a case in which the care, custody, or control exclusion did not apply is *Connecticut Fire Insurance Co. v. Reliance Insurance Co.*<sup>198</sup> In that case, the insured leased land from his brother. The leased land contained structures and equipment belonging to the brother. The lessee used the structures and equipment in varying degrees. A fire occurred on the leased premises as a result of the negligence of the lessee's employees. The fire destroyed goods of the lessor's brother that had been left in several of the structures.<sup>199</sup> The lessee's insurance company refused to pay for the destroyed goods because they had been left in the care, custody, or control of the lessee and were excluded from coverage under the policy.<sup>200</sup> The lessee ultimately prevailed against his insurance company because the court found that the lessee rarely, if ever, actually used the property, even though the property had been left on the leased premises.<sup>201</sup>

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193. *Id.* at 359.

194. 190 Cal. App. 2d 226, 11 Cal. Rptr. 908 (1961).

195. *Id.* at 228, 11 Cal. Rptr. at 909.

196. *Id.* at 231-32, 11 Cal. Rptr. at 910-12.

197. *Id.* at 233-34, 11 Cal. Rptr. at 912.

198. 208 F. Supp. 20 (D. Kan. 1962).

199. *Id.* at 22.

200. *Id.* at 23.

201. *Id.* at 25.

### C. Motor Vehicle Exclusion

The FCLP is not designed to provide coverage for bodily injury and property damage arising out of the ownership, maintenance, or use of motor vehicles, including loading and unloading of trailers and semi trailers. Instead, coverage for such events must be obtained via an automobile liability policy. The FCLPs usually describe motor vehicles as being any land motor vehicle, trailer, or semi trailer designed for travel on public roads, including any machinery or apparatus attached thereto.

Farm tractors, trailers, implements, or vehicles in use on the farm not subject to motor vehicle registration, or any other equipment designed for use principally off public roads, are not excluded from coverage. As a result, litigation frequently arises as to whether the particular piece of machinery is subject to motor vehicle registration. If it is subject to motor vehicle registration, it falls under the motor vehicle definition and is excluded from coverage.

In *North Star Mutual Insurance Co. v. Moon*,<sup>202</sup> the insured purchased a three wheeler for use on the insured's farm premises. The insured's FCLP covered off-terrain vehicles used on the farm so long as they were not subject to motor vehicle registration and were used exclusively on the farm premises. The insured frequently used the three wheeler to travel between noncontiguous farm land parcels. The insured modified the three wheeler by installing a mirror, horn, and brake light, registered the vehicle with the Department of Public Safety, and obtained a license for the vehicle.<sup>203</sup> The vehicle was eventually involved in an accident while driven by the insured's fourteen-year-old daughter. A passenger on the vehicle was seriously injured and brought suit. The insured's carrier denied coverage because the three wheeler was modified for use on the public highways and was licensed for such use.<sup>204</sup> The court agreed with the insurance company and held that an accident occurring on a public road with a modified ATV was not the sort of risk contemplated by the insurance carrier under the farm liability policy. As a result, the motor vehicle exclusion applied and there was no coverage.<sup>205</sup>

A court reached a different conclusion in *Utah Farm Bureau Mutual Insurance Co. v. Orville Andrews & Sons*.<sup>206</sup> In that case, a two-ton Ford truck was modified as a spread feeder for cattle. Although the

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202. 357 N.W.2d 95 (Minn. 1984).

203. *Id.* at 96.

204. *Id.*

205. *Id.* at 97-98.

206. 665 P.2d 1308 (Utah 1983).

truck was used year round on the insured's feedlots, it was used occasionally on public roads for an eleven-mile round trip to carry feed. A traffic accident occurred when the truck was on a public highway.<sup>207</sup> The insurance company denied coverage on the basis that the vehicle met the motor vehicle exclusion contained in the insurance policy. The court, however, found that the truck was always used for agricultural purposes and was never used for personal transportation. As a result, the court refused to apply the motor vehicle exclusion to a piece of equipment that obviously was used for agricultural purposes and was in the process of satisfying an agricultural purpose when the accident occurred.<sup>208</sup>

Similarly, the court also found coverage in *Heitkamp v. Milbank Mutual Insurance Co.*,<sup>209</sup> in which a pickup truck was used for both agricultural and nonagricultural purposes. The insurance policy excluded farm implements from the motor vehicle exclusion. The court found the term "implement" to be ambiguous, and held that it could either include or exclude a pickup that occasionally was used for nonagricultural purposes.<sup>210</sup> The court found that the accident was covered, even though the accident occurred on a public highway and did not involve an agricultural use at the time, because the pickup was a farm implement purchased for use on the family farm, was depreciated by the insured on the insured's income tax filing as a farming operation expense, and because the farm had priority of use as to the pickup.<sup>211</sup>

#### *D. Aircraft Exclusion*

The basic farmer's FCLP contains two aircraft exclusions. The first exclusion typically states: "This coverage does not apply to bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of any aircraft."<sup>212</sup> The second exclusion commonly states: "This coverage does not apply to property damage arising out of any substance released or discharged from any aircraft."<sup>213</sup>

These exclusions obviously are designed to exclude coverage for farmers and ranchers who use aircraft as a part of their operations. Although the use of aircraft may seem exotic to some farmers, aircraft are a necessary tool for many large western and southwestern farms and

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207. *Id.* at 1309.

208. *Id.* at 1310.

209. 383 N.W.2d 834 (N.D. 1986).

210. *Id.* at 837.

211. *Id.* at 836.

212. See, e.g., FC&S BULLETINS, *supra* note 26, Aug. 1990, at Farms Ap-6, 7.

213. *Id.*

ranches. To obtain coverage for the use of aircraft on the farm, the farmer must pay an extra premium and obtain a special endorsement to the insurance policy.

However, some courts narrowly interpret the exclusions to find coverage. In *Southern Farm Bureau Casualty Insurance Co. v. Adams*,<sup>214</sup> the insureds hired an aviation company to spray their cotton crop. The aviation company accidentally sprayed an innocent bystander who suffered serious personal injury. When a suit was filed against the insureds for the negligent conduct of the aerial sprayer, the insureds sought protection under their FCLP.<sup>215</sup> The insurance company, however, denied coverage on the basis of the standard aircraft exclusions found in the insured's policy. The insurance company took the position that the term "use" in the policy meant more than actually piloting the plane.<sup>216</sup> The court, however, agreed with the insureds' argument that use meant something more than simply hiring a plane for aerial spraying. The court found that there had to be some sort of personal involvement. Because the insureds were not personally involved in piloting the airplane, coverage was found under the policy.<sup>217</sup>

Courts also have held that there must be a causal connection between the use of the aircraft and the resulting damage before the aircraft exclusion applies. In *Little v. Kalo Laboratories, Inc.*,<sup>218</sup> a rice farmer used aerial spraying to put 2-4-D on his rice crop. An antidrift agent was used with the chemical. Nevertheless, the 2-4-D spread to a neighboring cotton farm and caused extensive damage. It was determined that the chemical spread when it became granulated after being applied to the rice crop, and was then wind-driven on to the cotton crop.<sup>219</sup> The rice farmer's insurance carrier contended that there was no coverage for the damage to the neighboring crop because of the aircraft exclusion contained in the insured's FCLP.<sup>220</sup> The court, however, refused to apply the exclusion because there was no causal connection between the aerial spraying and the subsequent damage to the cotton crop.<sup>221</sup>

### VIII. CONCLUSION

Professors Harnett and Thornton stated in their article on the insurable interest doctrine that "the creation and enforcement of insurance

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214. 570 S.W.2d 567 (Tex. Ct. App. 1978).

215. *Id.* at 569.

216. *Id.*

217. *Id.* at 570-71.

218. 406 So. 2d 678 (La. App. 1981).

219. *Id.* at 679.

220. *Id.* at 689.

221. *Id.* at 682-83.

contracts impinge at every turn upon the public interest and vitally affect the social and economic welfare of individuals."<sup>222</sup> Farmers, like everyone else, need insurance coverage for their activities, and given the potential for liability claims arising from farming activities, it is only prudent that farmers carry comprehensive liability insurance. However, the standard FCLP does not cover all of the liability claims that a farmer may face. Farmers must, therefore, be made aware not only of the coverage benefits found in the standard FCLP, but also of the coverage deficiencies of such policies.

It is only by fully understanding how such policies work that a farmer can decide what additional insurance coverages may be necessary to provide the maximum amount of liability coverage for the farmer's particular operation. For example, a farmer with a chemically intensive operation or an operation with potential for significant animal waste runoff would want to consider obtaining separate pollution coverage. Conversely, a farmer who has adopted low chemical input practices or who does not maintain lagoons for animal waste conceivably could get by on the standard FCLP.

Unfortunately, many farmers, like the rest of us, often are ignorant of the terms and provisions contained in their liability insurance policies. Even more unfortunately, enlightenment often comes only after a liability claim has arisen and the insurer denies coverage. Too often it is only after the farmer has opened his or her land to the public for recreational purposes to bring in a few extra dollars and an invitee is injured that the farmer learns of the significance of the business pursuits exclusion. The same applies to many other exclusions found in the standard FCLP. This Article analyzes some of the more common and recurring problem areas, and hopefully will assist farmers and those who represent them to deal more intelligently with their insurers.

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222. Harnett & Thornton, *Insurable Interest in Property: A Socio-Economic Reevaluation of a Legal Concept*, 48 COLUM. L. REV. 1162 (1948).

# **Federal Court Jurisdiction Over USDA/ASCS Cases: How and In What Courts Farmers Can Seek Review of USDA Denials of Their Farm Subsidy Payments**

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**SHELLEY L. BAGOLY\*\***

## **I. BACKGROUND OF USDA/ASCS PROGRAMS PROVIDING SUBSIDIES TO FARMERS**

For decades, Congress has passed acts promulgating differing types of farm programs that entitle farmers to subsidy payments. The United States Department of Agriculture (USDA) is the executive agency charged with implementing these federal farm subsidies. Within USDA, the Commodity Credit Corporation (CCC), through its Charter Act, technically administers the programs.<sup>1</sup> However, the day-to-day operations of programs are performed by employees of USDA's Agricultural Stabilization and Conservation Service (ASCS).<sup>2</sup> In essence, farmers throughout the country sign up for programs with and receive their checks from their local ASCS office, of which there are some 3,000 nationwide.

The Secretary of Agriculture uses local ASCS committees to carry out and enforce the farm programs.<sup>3</sup> The local committees, known as "County Committees," are composed of farmers from the county elected by other farm producers in that county.<sup>4</sup> The County Committees review and vote to approve or to disapprove each farmer's application for participation in the farm programs. If a farmer is unhappy with the determination, he can ask for a reconsideration hearing. If the farmer is again denied payments, he can appeal to the State Committee, which consists of farmers from the state selected by the Secretary of Agriculture (Secretary). Farmers can appeal state ASCS determinations to the national ASCS office in Washington, D.C., headed by the Deputy Administrator, State and County Operations (DASCO). DASCO oversees the programs,<sup>5</sup> renders final determinations in administrative appeals,<sup>6</sup> and supervises the county and state ASCS committees and their staffs.

As part of the regulatory scheme to control farm subsidies, farmers are subject to a \$50,000 limitation per "person" in the amount of

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1. 15 U.S.C. § 714c(g) (1988).

2. 7 C.F.R. §§ 2.21, 2.65 (1990).

3. 16 U.S.C. § 590(h), (b) (1988); 7 C.F.R. § 7.21 (1988).

4. *Id.*

5. 7 C.F.R. § 1421.2 (1990).

6. Administrative appeals are conducted in accordance with 7 C.F.R. § 780 (1990).

payments they may receive. In part, the "payment limitations" provision states:

Notwithstanding any other provision of law:

(1) For each of the 1986 through 1990 crops, the total amount of payments (excluding disaster payments) that a *person* shall be entitled to receive under one or more of the annual programs established under the Agricultural Act of 1949 (7 U.S.C. § 1421 *et seq.*) for wheat, feed grains, upland cotton, extra long staple cotton, and rice may not exceed \$50,000.<sup>7</sup>

Although Congress has never defined the term "person," Congress has directed the Secretary to issue regulations defining the term "person."<sup>8</sup> These regulations are set forth in the Code of Federal Regulations.<sup>9</sup>

Every spring, each farmer (whether as an individual, a partnership, or a corporation) includes, in his application to the County Committee, a request to be determined as one or more "persons" for payment limitation purposes. If the farmer disagrees with the number of "persons" he is awarded, an appeal by right through the three-prong administrative hearing system mentioned above may follow.

These so-called hearings are not "adjudications" as defined by the Administrative Procedures Act.<sup>10</sup> Instead, they are informal hearings — more in the form of question and answer sessions — in which the farmer has both the obligation and burden of proving and establishing his right to a specific number of "persons." The Government is not required to present its case; likewise, the right to discovery and the rules of evidence do not apply.<sup>11</sup>

County committee hearings result in a brief (two to three page) written determination written by the county committee members. State committee determinations are seldom much longer, and DASCO final determinations, in only rare cases, contain findings of fact or conclusions of law. Therefore, it is common for a farmer who receives an unfavorable DASCO decision to want to seek review in a federal court. The controlling

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7. Food Security Act of 1985, Pub. L. No. 99-198, § 1001, 99 Stat. 1354 (current version at 7 U.S.C. § 1308 (1988)) (emphasis added). This provision represented the legislative authority to conduct a payment limitation program for the 1986 crop year. The provision covers the 1987 through 1990 crop years. *Id.*

8. See 7 U.S.C. § 1307(4) (1988).

9. 7 C.F.R. § 1497.3(b) (1990). These new regulations were authorized by the Agricultural Reconciliation Act of 1987, Pub. L. No. 100-203, § 1303, 101 Stat. 1330. For contract years prior to 1989, see 7 C.F.R. § 795.

10. 5 U.S.C. § 551 (1988). See *Hilburn v. Butz*, 463 F.2d 1207 (5th Cir.), *cert. denied*, 410 U.S. 942 (1972). But see *Prosser v. Butz*, 389 F. Supp. 1002 (N.D. Iowa 1974).

11. See 7 C.F.R. § 780.8 (1990) for the nature of these informal hearings.

statutes and the case law, however, are confusing. This Article analyzes the two federal courts to which ASCS appeals can be taken, the history and limits of their jurisdiction, the arguments that the Government frequently makes to dismiss certain cases brought in each court, and the recent developments within these courts.

## II. JUDICIAL REVIEW OF ASCS CASES IN FEDERAL COURTS

### A. *United States Claims Court Jurisdiction*

Congress has enacted two distinct, but in practice almost identical, statutes that provide jurisdiction in the United States Claims Court for claims against the United States.<sup>12</sup> These statutes together are commonly referred to as the Tucker Act. The main difference between the two is that under section 1346(a)(2), district courts and the Claims Court are vested with concurrent jurisdiction if the claim is less than \$10,000, while section 1491 deals only with the Claims Court's jurisdiction.<sup>13</sup> In sum, the Claims Court has jurisdiction over all claims against the Government involving a breach of contract, whereas the district courts' jurisdiction ceases whenever a monetary claim exceeds \$10,000.<sup>14</sup>

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12. 28 U.S.C. § 1346(a)(2) (1988); *id.* § 1491(a)(1). Section 1346(a)(2) states as follows:

Any other civil action or claim against the United States, not exceeding \$10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort, except that the district courts shall not have jurisdiction of any civil action or claim against the United States founded upon any express or implied contract with the United States or for liquidated or unliquidated damages in cases not sounding in tort which are subject to sections 8(g)(1) and 10(a)(1) of the Contract Disputes Act of 1978. For the purpose of this paragraph, an express or implied contract with the Army and Air Force Exchange Service, Navy Exchanges, Marine Corps Exchanges, Coast Guard Exchanges, or Exchange Councils of the National Aeronautics and Space Administration shall be considered an express or implied contract with the United States.

Section 1491(a)(1) states:

The United States Claims Court shall have jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. For the purpose of this paragraph, an express or implied contract with the Army and Air Force Exchange Service, Navy Exchanges, Marine Corps Exchanges, Coast Guard Exchanges, or Exchange Councils of the National Aeronautics and Space Administration shall be considered an express or implied contract with the United States.

13. 28 U.S.C. § 1491(a)(1) (1988).

14. *Id.* § 1346(a)(2).

With respect to jurisdiction in the Claims Court, whether a dispute over subsidy payments between a farmer and USDA is a breach of contract or a dispute involving administrative procedure, such as arbitrary or capricious action, can be critical. This is because the Claims Court's scope of review and its jurisdiction are limited.

The Government generally argues that disputes over farm subsidies are breach of contract suits and not suits for administrative review, and thus should be heard in the Claims Court. This is because contract disputes fit clearly under the Tucker Act while administrative review cases are more within the province of district courts where jurisdiction and relief are more liberal. This insistence by the Government began in the mid-1980s when subsidy payments became a substantial and critical part of most farmers' incomes, and thus became increasingly the subject of litigation:

[A]fter the shift in the 1983 Payment-In-Kind (PIK) program to the use of binding contracts to guarantee producer compliance with farm program commitments, the USDA and the Justice Department began relying on the Tucker Act, which provides that actions rooted in breach of contract which ask for money damages of more than \$10,000 must be brought in the U.S. Court of Claims.<sup>15</sup>

Both USDA and the United States Department of Justice prefer to defend ASCS cases in the Claims Court rather than in federal district courts. Essentially, the preference is because the Claims Court views its scope of review as a limited one — that is, determining whether the agency's ruling had a "rational basis" — a narrow avenue of relief that is usually decided on joint motions for summary judgment rather than in trials.<sup>16</sup> In contrast, federal district courts are more likely to open the record for new evidence, to examine the evidence and the policy behind the program under a broader scope of review, to allow testimony, to consider granting injunctive and/or declaratory relief, and to more closely examine issues of due process.<sup>17</sup> Therefore, the Government has repeatedly relied on the Tucker Act's \$10,000 cap to keep ASCS cases in the Claims Court, or to force a transfer of federal district cases to the Claims Court.<sup>18</sup>

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15. Hamilton, *Legal Issues Arising in Federal Court Appeals of ASCS Decisions Administering Federal Farm Programs*, 12 HAMLINE L. REV. 633, 635 (1989) (citations omitted).

16. See, e.g., Carruth v. United States, 627 F.2d 1068, 1076 (1980); Raines v. United States, 12 Cl. Ct. 530, 537 (1987).

17. See, e.g., Esch v. Yeutter, 876 F.2d 967 (D.C. Cir. 1989), *modifying* Esch v. Lyng, 665 F. Supp. 6 (D.D.C. 1987).

18. Divine Farms, Inc. v. Block, 679 F. Supp. 867, 869 (S.D. Ind. 1988); Gibson v. Block, 619 F. Supp. 1572, 1577 (N.D. Ind. 1985).

Many ASCS cases involve allegations of error in USDA administrative procedure. Although these administrative mistakes or omissions can severely prejudice farmers, they are often found inappropriate for Claims Court review.<sup>19</sup> On the other hand, district courts are more willing to review farm subsidy cases that contain issues of due process or arbitrary or capricious action, stressing the limited scope of the Claims Court's jurisdiction and review.<sup>20</sup>

In addition, certain causes of action, by their nature, preclude Claims Court jurisdiction, despite the Government's preference for that court. It is well settled that the Claims Court does not have jurisdiction to hear claims that are essentially equitable in nature.<sup>21</sup> For example, the Tucker Act<sup>22</sup> does not apply to regulations that are not "money mandating" or to claims that are discretionary.<sup>23</sup>

The Claims Court may not review claims for denial of due process, declaratory judgments, and injunctive relief.<sup>24</sup> This is important because the right to seek injunctive relief or to obtain a quick declaratory judgment can be critical to farmers who need immediate review by federal courts to avoid the impending disaster of bankruptcy or foreclosure. Further, many complaints seeking injunctive relief also seek declaratory judgments. For farmers, a declaratory judgment concerning their rights to payment can be dispositive when determining whether they will receive payments and how many "person" payments they are entitled to.

Bringing suit in Claims Court also may create costly delays. Farmers prefer not to be in the Claims Court because they must wait for USDA's payment deadline to pass before they can actually file suit — prompt receipt of payments is critical to most farmers' existence.<sup>25</sup>

Finally, because there is a strong preference in Claims Court to rule by summary judgment, Claims Court judges often deny plaintiffs the right to discovery. In the last four cases prosecuted by the authors, the

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19. Raines v. Block, 599 F. Supp. 196, 198 (D. Colo. 1984), *appeal dismissed*, 798 F.2d 377 (10th Cir. 1986).

20. See *infra* notes 65-68 and accompanying text.

21. See, e.g., Esch v. Yeutter, 876 F.2d 976, 982 (D.C. Cir. 1989), *modifying* Esch v. Lyng, 665 F. Supp. 6 (D.D.C. 1987); Pope v. United States, 9 Cl. Ct. 479 (1986).

22. 28 U.S.C. § 1491(a) (1988).

23. Kelly, *In Depth - ASCS Appeals: The equitable authority of DASCO*, AGRIC. L. UPDATE, June 1990, at 6 (citing United States v. Mitchell, 463 U.S. 206, 218-24 (1983)).

24. C. KELLEY & J. HARBISON, A LAWYER'S GUIDE TO ASCS ADMINISTRATIVE APPEALS AND JUDICIAL REVIEW OF ASCS DECISIONS 83 (1990) (citing Morgan v. United States, 12 Cl. Ct. 247, 253 (1987) and Carruth v. United States, 627 F.2d 1068, 1081 (Ct. Cl. 1980)).

25. See generally Pires & Knishkowy, *Jurisdictional Issues in Payment Limitation Cases*, 2 FARMERS' LEGAL ACTION REPORT (Nov.-Dec. 1987).

judge allowed discovery in only one case. It has been the authors' experience, as plaintiff farmers' lawyers, that these limitations on jurisdiction and review make the Claims Court, at times, a poor choice for the farmer needing relief and review of a case involving administrative error by ASCS or in a case requiring quick injunctive or declaratory relief. Thus, lawyers representing farmers are advised to look to federal district courts for relief.

### *B. United States District Court Jurisdiction*

District courts have concurrent jurisdiction with the Claims Court if the action against the Government does not exceed \$10,000.<sup>26</sup> District court jurisdiction is vested under 28 U.S.C. § 1331 for civil actions arising "under the Constitution, laws, or treaties of the United States."<sup>27</sup> As stated earlier, although section 1331 provides jurisdiction over claims for injunctive relief, it has no application when money damages exceed \$10,000.<sup>28</sup> However, in some cases, even though the monetary benefit at issue exceeded \$10,000, the plaintiff was entitled to seek relief in United States District Court.

In the most famous case, *Bowen v. Massachusetts*,<sup>29</sup> the United States Supreme Court held that a claim may be maintained in a district court even though the ultimate effect of the court's order may result in the payment by the United States in excess of \$10,000.<sup>30</sup> In *Bowen*, the Court repudiated the idea that suits seeking monetary relief from the Federal Government are by definition suits seeking "money damages" cognizable only in the Claims Court.<sup>31</sup> The Court relied on an analysis of two provisions of the Administrative Procedures Act (APA).<sup>32</sup>

First, the Court examined section 702, which involves the APA's waiver of federal sovereign immunity. Section 702 states in part:

The United States may be named as a defendant in any such action, and a judgment or decree may be entered against the United States. . . . Nothing herein (1) affects other limitations on judicial review or the power or duty of the court to dismiss

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26. 28 U.S.C. § 1346(a)(1) (1988).

27. *Id.* § 1331.

28. *Id.* § 1346. This statute is commonly known as the federal question statute. Declaratory judgments are authorized under 28 U.S.C. § 2201 (1988). See Linden, *An Overview of the Commodity Credit Corporation and the Procedures and Risks of Litigating Against It*, 11 J. AGRIC. TAX'N L. 305, 326 (1990).

29. 487 U.S. 879 (1988).

30. *Id.* at 910-12.

31. *Id.* at 893.

32. 5 U.S.C. §§ 702, 704 (1988).

any action or deny relief on any other appropriate legal or equitable ground; or (2) confers authority to grant relief if any other statute that grants consent to suit expressly or impliedly forbids the relief which is sought.<sup>33</sup>

Second, the Court analyzed section 704's limitation on reviewability of "final agency action," which states that review is allowed only if there is no other adequate remedy in a court:

Agency action made reviewable by statute and final agency action for which there is no other adequate remedy in a court are subject to judicial review. A preliminary, procedural, or intermediate agency action or ruling not directly reviewable is subject to review on the review of the final agency action. Except as otherwise expressly required by statute, agency action otherwise final is final for the purposes of this section whether or not there has been presented or determined an application for a declaratory order, for any form of reconsideration, or, unless the agency otherwise requires by rule and provides that the action meanwhile is inoperative, for an appeal to superior agency authority.<sup>34</sup>

The *Bowen* Court concluded that federal district courts may review agency actions (1) when monetary relief might ensue from a so-called breach of a federal contract if the claim can be construed as more than a monetary claim<sup>35</sup> and (2) when the alternate court (Claims Court) is untenable for purposes of providing adequate relief.<sup>36</sup>

In 1989, the District of Columbia Circuit Court in *Esch v. Yeutter*<sup>37</sup> applied *Bowen* to a farm subsidy case. However, to best understand *Esch*, it is instructive to review the district court's decision in *Esch* and a companion case brought about the same time in another district court.

In *Esch v. Lyng*,<sup>38</sup> which was decided one year prior to *Bowen*, the government determined that nine brothers and sisters were only one "person" for payment limitation purposes.<sup>39</sup> Although the plaintiffs could have brought claims for monies past due, they relinquished those claims in district court to avoid a Tucker Act transfer.<sup>40</sup> Instead, the plaintiffs

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33. *Id.* § 702.

34. *Id.* § 704.

35. *Bowen*, 879 U.S. at 900-01.

36. *Id.* at 905.

37. 876 F.2d 976 (D.C. Cir. 1989), *modifying* *Esch v. Lyng*, 665 F. Supp. 6 (D.D.C. 1987).

38. 665 F. Supp. 6 (D.D.C. 1987).

39. *Id.* at 10.

40. *Id.* at 11.

sought (1) injunctive relief, prohibiting the Secretary from suspending their participation in the farm program as nine persons; (2) a declaration that they were eligible to participate as nine “persons”; and (3) an order (pursuant to the APA) setting aside ASCS’s “person” determination as arbitrary and capricious, in violation of due process, and unwarranted by the facts.<sup>41</sup>

The district court recognized that the Claims Court would have exclusive jurisdiction if “the primary object of a suit is to recover money damages from the United States in excess of \$10,000.”<sup>42</sup> However, the court noted that if a plaintiff seeks equitable relief that would have “significant prospective effect or considerable value” other than monetary liability, the district court could assume jurisdiction over the nonmonetary claims.<sup>43</sup>

The *Esches* not only disavowed all claims for monies past due, but also produced evidence that a preliminary injunction would “immediately inure to their benefit by placating creditors who at the moment were threatening to shut down plaintiffs’ farm.”<sup>44</sup> Thus, the district court granted plaintiffs’ injunction and found, *inter alia*, that the defendants had denied the plaintiffs a fair and impartial administrative hearing and that the Government’s decision was reached in violation of due process.<sup>45</sup> The district court’s holding was remarkably close to the soon-to-be rationale in *Bowen*.<sup>46</sup>

The Government appealed to the District of Columbia Circuit — essentially because the district court’s decision represented a challenge to their long-standing policy that farmer-plaintiffs, disgruntled with the administrative process of determining their subsidy payments, could seek relief only in Claims Court.<sup>47</sup>

Shortly thereafter, a second federal district court reached a jurisdictional conclusion similar to *Esch*. In *Justice v. Lyng*,<sup>48</sup> the plaintiffs brought an action for a declaratory judgment regarding their eligibility to participate in an Agricultural Stabilization and Conservation Service (ASCS) program. The Government again argued that such a judgment would result in the plaintiffs’ receiving money damages in excess of \$10,000, and thus should trigger the Tucker Act.<sup>49</sup> The court ruled,

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41. *Id.* at 15.

42. *Id.* at 11.

43. *Id.* (citation omitted).

44. *Id.* at 12.

45. *Id.* at 23.

46. See *supra* notes 29-36 and accompanying text.

47. See *Esch*, 876 F.2d at 977-78.

48. 716 F. Supp. 1567 (D. Ariz. 1988).

49. *Id.* at 1568.

however, that plaintiff's action was not an action for "actual, presently due money damages from the United States," but rather an action seeking a determination that plaintiffs were eligible to participate in a program from which benefits could be earned.<sup>50</sup>

In sum, *Esch* and *Justice* introduce the premise that district court jurisdiction over farm subsidy cases is necessary and rational.<sup>51</sup> Together, these two cases held that the Tucker Act does not preclude a district court from reviewing an agency action when the relief sought is something other than money damages, even when the relief may form the basis for a money judgment.<sup>52</sup>

In 1989, the District of Columbia Circuit Court of Appeals affirmed the district court's decision in *Esch v. Lyng* (and, by association, *Justice v. Lyng*).<sup>53</sup> The decision included language directly negating Judge Oberdorfer's "contract" holding in *Baker v. United States*<sup>54</sup> that farm subsidy disputes are contract claims.

If appellees' suit is not based on a contract with the Federal Government, it cannot lie within the Claims Court's contractual jurisdiction. See 28 U.S.C. § 1491(a). Although appellees signed "contracts" with the Federal Government, and although the Department's regulations denominated the documents executed by the Federal Government and program participants as "contracts," see 7 C.F.R. § 704.1 (1988) (conservation reserve program); *id* §§ 713.490, 713.50 (1988) (price support program), we see no reason to assume that what is involved here is a contract within the meaning of the Tucker Act. As the Supreme Court recently noted "[u]nlike normal contractual undertakings, federal grant programs originate in and remain governed by statutory provisions expressing the judgment of Congress concerning de-

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50. *Id.* (quoting *King v. United States*, 395 U.S. 1, 3 (1969)).

51. At the same time, a case somewhat similar to *Esch v. Lyng*, *Baker v. Lyng*, No. 87-1643-LFO (D. D.C. Aug. 4, 1987) was brought in the United States District Court for the District of Columbia. The plaintiffs disavowed any claim for monetary damages, sought APA review of USDA's "person" determination, and just as the *Esch* plaintiffs, sought declaratory and injunctive relief. Judge Oberdorfer ignored *Esch v. Lyng* and dismissed the *Baker* action, ruling that the district court lacked subject matter jurisdiction. *Id.* He found the case to be "a suit on a government contract" to be brought in the Claims Court. *Id.* Judge Oberdorfer relied on the CCC anti-injunction statute (discussed *infra* note 77 and accompanying text) as authority for dismissal. *Id.*

52. *Tennessee Leech v. Dole*, 749 F.2d 331, 336 (6th Cir. 1984), *cert. denied*, 472 U.S. 1018 (1985); 716 F. Supp. at 1568 (citing *Laguna Hermosa Corp. v. Martin*, 643 F.2d 1376, 1379 (9th Cir. 1981)).

53. *Esch v. Yeutter*, 876 F.2d 976 (D.C. Cir. 1989).

54. No. 87-1643-LFO (D.D.C. Aug. 4, 1987).

sirable public policy." [Appellees'] claims arise under a federal grant program and turn on the interpretation of statutes and regulations rather than on the interpretation of an agreement negotiated by the parties. It seems to us, then, that [appellees'] claims are not contract claims for Tucker Act purposes.<sup>55</sup>

In *Esch v. Yeutter*, the court went to great lengths to align itself with the Supreme Court's recent decision in *Bowen v. Massachusetts* which held that the Claims Court has inadequate procedures to review what are essentially administrative procedure (APA) cases:

[I]t is doubtful that the jurisdictional power of the Claims Court extends to the suit in question. Appellees, we repeat, assert no claim for a sum immediately due and owing by the Federal Government. The statute undergirding their suit does not mandate compensation. Similarly to the one involved in *Bowen*, it "directs the Secretary to pay money[,] . . . not as compensation for a past wrong, but to subsidize future . . . expenditures." Nor do appellees predicate their bid for relief upon the provisions of the contract they have negotiated with the Department of Agriculture. And, like the *Bowen* Court, we believe that district courts are better equipped to understand and evaluate the various factual circumstance of these cases than in the Claims Court, headquartered in Washington, far removed from the controversy, and inconvenient to most of those likely to become litigants. Accordingly, we conclude that the Claims Court does not possess the kind of review procedures which would displace the District Court's APA jurisdiction over appellees' suit.<sup>56</sup>

The Court of Appeals for the District of Columbia Circuit addressed the issue of jurisdiction before reviewing the merits of the case. The Government argued that subject matter jurisdiction is in the United States Claims Court.<sup>57</sup> The Government attempted to portray the Esches' claim as one of money damages in excess of \$10,000, cognizable only in the Claims Court. However, because the complaint sought both monetary and equitable relief, the court was faced the identical multiple-claims dilemma addressed in *Bowen*.<sup>58</sup> In *Bowen*, the Supreme Court rejected the premise that actions involving money damages must be brought in the Claims Court.<sup>59</sup> The *Esch* court reviewed and parroted

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55. *Esch*, 876 F.2d at 978 n.13 (quoting *Maryland Dep't of Human Resources v. HHS*, 763 F.2d 1441, 1449 (D.C. Cir. 1985)).

56. *Id.* at 985 (citations omitted).

57. *Id.* at 978.

58. *Id.* at 984.

59. *Bowen*, 487 U.S. at 904-05.

the Supreme Court's analysis in *Bowen*, which invoked a two-part test to determine whether a suit was cognizable under the APA.<sup>60</sup> The circuit court traced the analytical line traveled by the Supreme Court in *Bowen* with regard to sections 702 and 704 of the APA, and concluded that the district court possessed jurisdiction over the action.<sup>61</sup>

Addressing the section 702 inquiry, the *Esch* court noted that the appellees sought an injunction against an arbitrary or capricious administrative denial of subsidy payments due to them. The court found that the suit for relief was "certainly not an action for money damages."<sup>62</sup> The court held that the Esches' contention that the Government procedures were flawed and required a redetermination through a fair and impartial hearing was a plea for more than money damages and compensation for legal injury.<sup>63</sup> In a footnote, the court sagely pointed out that "[o]f course, appellees hope that upon a redetermination conducted properly, the evidence will lead to a finding that they are entitled to receive money from the Federal Government, but this result is by no means assured or compelled by the injunction they presently request."<sup>64</sup> The court also noted the speculative nature of appellees' claim because the Government, on redetermination, could again determine that appellees were not entitled to benefits.<sup>65</sup>

Finally, and most importantly for farmers seeking the right to have their day in district court, in conducting its section 704 analysis, the court questioned whether the Claims Court could provide the Esches with the sort of "'special and adequate review procedure' that will oust the district court of its normal jurisdiction under the APA."<sup>66</sup> The court opined that the Claims Court could *not* provide such review and that the Claims Court review was not an acceptable alternative to APA review in district court.<sup>67</sup>

The court's reasoning included the following: The Claims Court lacked equitable jurisdiction to award injunctive relief; the Esches asserted

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60. *Esch*, 876 F.2d at 979 (citations omitted).

61. *Id.* at 983.

62. *Id.* at 984 (citing *Bowen*, 487 U.S. at 893).

63. *Id.* The *Esch* court went a step further and stated, "Indeed, the monetary aspect of any relief appellees might be entitled to, is much more a matter of guess work than either *Bowen* or *National Association of Counties* involved." *Id.* In *Bowen*, reversal of the administrative decision on the merits resulted in payment of money from the Federal Treasury. *Id.* (citations omitted). In *National Ass'n of Counties v. Baker*, 842 F.2d 369, 371 (1988), the injunction issued against the Secretary forced the release of specific funds withheld.

64. *Esch*, 876 F.2d at 984 n.68.

65. *Id.* at 984.

66. *Id.* (quoting *Bowen*, 487 U.S. 904) (citations omitted).

67. *Id.*

no claim for a sum immediately due and owing; the underlying statute did not mandate compensation; the Esches did not predicate their claim for relief upon the contract with defendant; and the court's adoption of the *Bowen* conclusion that "district courts are better equipped to understand and evaluate the various factual circumstances of these cases than is the [United States] Claims Court . . . [which is] far removed from the controversy and inconvenient to most of those likely to become litigants."<sup>68</sup>

In sum, with the help of *Bowen*, *Esch* has made the United States district courts an alternative for farmers seeking review of their farm subsidy payment cases.

### *C. Government's Continuing Opposition to Judicial Review in United States District Courts*

Despite *Esch v. Yeutter*, the government continues to challenge farmers who bring suit in district courts. Their four remaining defenses are briefly summarized below.

1. *The Tucker Act Defense*.—The Government's first line of defense in most cases is that the Tucker Act mandates that all claims for breach of contract exceeding \$10,000 be adjudicated in Claims Court. Generally, ninety-nine percent of all ASCS cases involve farmers who are denied participation and monies well in excess of \$10,000 (typical cases are in the \$50,000 to \$250,000 range).<sup>69</sup> It has been the authors' experience that during the past four years the government has filed a motion to dismiss alleging lack of subject matter jurisdiction by reason of the Tucker Act in all suits brought in United States district courts.

2. *The CCC Charter Act Defense*.—The Commodity Credit Corporation ("CCC"), a federal corporation,<sup>70</sup> is technically vested with congressional authority to implement farm subsidy programs. Whether CCC is named as a party or not, the Government contends that any lawsuit involving farm subsidy monies (CCC funds) must have a basis for jurisdiction in federal district court separate from the CCC's Charter Act.<sup>71</sup> The Government often prevails on its contention that the Charter Act itself does not vest jurisdiction in the federal district courts to hear ASCS cases. Although the jurisdictional hurdle was overcome in cases

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68. *Id.* at 985.

69. A massive reorganization of American farms took place during 1986-1989, at which time hundreds of thousands of "persons" were created through the formation of new partnerships and corporations. This made the one—"person," mom and pop farm receiving one \$50,000 person payment much less prevalent, even in the most rural of areas.

70. 15 U.S.C. §§ 714-714(b) (1988).

71. *Id.* § 714(c).

such as *Robinson v. Block*,<sup>72</sup> *Esch v. Lyng*,<sup>73</sup> *Justice v. Lyng*<sup>74</sup> and *Esch v. Yeutter*,<sup>75</sup> other courts have held that actions involving CCC-funded ASCS programs must be brought in the Claims Court if the amount of relief sought exceeds \$10,000.<sup>76</sup>

In addition, the Government often cites a separate part of the CCC Charter Act to keep farmers out of federal district court if the suit involves a plea for injunctive relief. This provision, the Charter Act's "Anti-Injunction" provision, states that CCC "[m]ay sue and be sued, but no attachment, injunction, garnishment or other similar process . . . shall be issued against the Corporation or its property."<sup>77</sup> This argument was successfully used by the government in *Baker v. Lyng* and in other cases.<sup>78</sup> In contrast, other federal district courts have moved away from the "anti-injunction" preclusion of farmer-plaintiffs seeking injunctive relief in federal district courts.<sup>79</sup> However, until further clarification by the circuit courts, the anti-injunction defense will continue to be actively and successfully used by the Government.

3. *The Divine Farms Defense*.—In *Divine Farms, Inc. v. Block*,<sup>80</sup> the Government succeeded in forcing a farmer plaintiff from federal district court (and into the Claims Court) by persuading the court that plaintiff's claim for monetary damages predominated the claim for equitable relief.<sup>81</sup> The plaintiff sought a program determination or, in the alternative, \$90,000 in damages, and also sought injunctive relief. The court concluded that plaintiff's request for monetary damages predominated his claim for equitable relief because plaintiff's claimed injury could be redressed by an award of damages, and this would preclude

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72. 608 F. Supp 817, 819 (W.D. Mich. 1985).

73. 665 F. Supp. 6 (D.D.C. 1987).

74. 716 F. Supp. 1567 (D. Ariz. 1988).

75. 876 F.2d 976 (D.C. Cir. 1989).

76. See *United States v. O'Neil*, 767 F.2d 1111, 1113 (5th Cir. 1985); *Amalgamated Sugar v. Bergland*, 664 F.2d 818, 823 (10th Cir. 1981); *Raines v. United States*, 12 Cl. Ct. 530, 534 (1987); *Gibson v. United States*, 11 Cl. Ct. 6, 11 (1986); *Pettersen v. United States*, 10 Cl. Ct. 194, 197, *aff'd*, 807 F.2d 993 (Fed. Cir. 1986); *Gibson v. Block*, 619 F. Supp. 1572, 1575 (N.D. Ind. 1985); *Raines v. Block*, 599 F. Supp. 196, 198 (D. Colo. 1984).

77. 15 U.S.C. § 714b(c) (1988).

78. *Baker v. Lyng*, No. 87-1643-LFO (D.D.C. Aug. 4, 1987). See also *Stroud v. Benson*, 254 F.2d 448, 450 (4th Cir. 1958); *Moon v. Freeman*, 245 F. Supp. 837, 839 n.3 (E.D. Wash. 1965); *Lazer v. Benson*, 156 F. Supp. 259, 268 (E.D.S.C. 1957).

79. See *Iowa Miller v. Block*, 771 F.2d 347, 348 n.1 (8th Cir. 1985), *cert. denied*, 478 U.S. 1012 (1986); *Justice v. Lyng*, 716 F. Supp. 1567, 1569 (D. Ariz. 1988); *Mitchell v. Block*, 551 F. Supp. 1011, 1015-16 (W.D. Va. 1982).

80. *Divine Farms, Inc. v. Block*, 679 F. Supp. 867 (S.D. Ind. 1988).

81. *Id.* at 871.

any need for equitable relief.<sup>82</sup> The court found equitable relief "incidental" to the remedy requested — money.<sup>83</sup> The *Divine Farms*' defense is in direct conflict with *Esch v. Yeutter*, thus requiring farmers' lawyers to carefully draft their complaints.<sup>84</sup>

4. *The Finality Defense*.—When all else fails, the Government always cites the finality rule. Pursuant to 7 U.S.C. §§ 1385 and 1429, decisions of CCC (ASCS determinations) are final and are not reviewable by district courts.<sup>85</sup> This defense was crippled in *Esch v. Yeutter*,<sup>86</sup> and appears to be losing favor in the USDA's Office of General Counsel.<sup>87</sup>

#### *D. Recent U.S. Claims Court Decisions Limit Relief Available To Farmers*

Since 1985, the United States Claims Court has heard approximately nineteen farm subsidy ASCS cases. A brief review of these cases reveals that farmers obtained meaningful relief in very few cases. The nineteen cases are listed below in chronological order.

##### *1985*

In *Amalgamated Sugar Co. v. United States*,<sup>88</sup> the court found that sugar beet processors who participated in the 1977 price support loan program were entitled to recover costs of storing sugar beyond the original maturity date of the loan. The regulations, prohibiting the accounting method used by the processors, only applied to the payment program, not to the loan program in which the processors participated.<sup>89</sup>

##### *1986*

In *Pettersen v. United States*,<sup>90</sup> the Government's determination that farmers were ineligible for the 1984 Feed Grain program was upheld.

In *Gibson v. United States*,<sup>91</sup> the court found that the Government's determination of a farmer's ineligibility for 1983 PIK program was not arbitrary or capricious.

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82. *Id.*

83. *Id.*

84. For an excellent, in-depth analysis of *Divine Farms* and its conflict with *Esch v. Yeutter*, see C. KELLEY & J. HARBISON, *supra* note 24 at 71-78.

85. 7 U.S.C. §§ 1385, 1429 (1988).

86. 876 F.2d 976 (D.C. Cir. 1989).

87. Interestingly, the government has never explained why the finality defense does not preclude review by the United States Claims Court.

88. 770 F.2d 1042, 1043 (Fed. Cir. 1985).

89. *Id.* at 1044.

90. 10 Cl. Ct. 194, 199, *aff'd*, 807 F.2d 993 (Fed. Cir. 1986).

91. 11 Cl. Ct. 6, 16 (1986).

In *Haupricht Brothers, Inc. v. United States*,<sup>92</sup> the Claims Court affirmed that farmers were found ineligible for 1983 PIK program.

### 1987

In *Hilo Coast Processing v. United States*,<sup>93</sup> the court held against the plaintiffs, but the Federal Circuit reversed, and found that the plaintiffs were eligible under the 1977 sugar crop price support payment program, and that the plaintiffs had been singled out for seemingly unfair treatment.

The plaintiff's case in *Morgan v. United States*<sup>94</sup> was dismissed for lack of jurisdiction.

In a case reviewing of a 1983 PIK program, *Raines v. United States*,<sup>95</sup> the plaintiffs sought relief in the form of wheat, diversion payments, treatment costs, and storage costs. The plaintiffs' claim for wheat due under the original contract term fell outside the Claims Court's "incidental equitable powers" under 28 U.S.C. § 1491(a)(1), and was dismissed because it could not be construed as a claim for money damages.<sup>96</sup>

*Hanson v. United States*<sup>97</sup> involved a 1977 FMHA regulation violation and breach of implied-in-fact contract. The court found that no cause of action for money damages existed under regulations and statutes implementing emergency agriculture loans.<sup>98</sup> The court held that it had no jurisdiction over due process claims.<sup>99</sup>

### 1988

*Willson v. United States*<sup>100</sup> involved the 1985 Price Support and Production Adjustment program. The court found that the ASCS decision in which plaintiffs were found to be one "person" was "rationally based."<sup>101</sup>

A 1984-85 Milk Diversion Program case, *O'Connell v. United States*,<sup>102</sup> was remanded to permit the farmer to present evidence.

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92. 11 Cl. Ct. 369, 374 (1986).

93. 816 F.2d 629, 634 (Fed. Cir. 1987).

94. 12 Cl. Ct. 247, 254 (1987).

95. 12 Cl. Ct. 530 (1987).

96. *Id.* at 535.

97. 13 Cl. Ct. 519 (1987).

98. *Id.* at 534.

99. *Id.* at 532.

100. 14 Cl. Ct. 300 (1988).

101. *Id.* at 309.

102. 14 Cl. Ct. 309, 317 (1988).

In another Milk Diversion Program case, *Grav v. United States*,<sup>103</sup> farmers on appeal alleged that the Secretary promulgated regulations inconsistent with the statutory scheme, and they prevailed.

In *Swartz v. United States*<sup>104</sup> the farmers, in this 1982-83 Commodity Price Support Program case, lost on the merits.

A civil penalty was assessed against the producers in *Parks v. United States*<sup>105</sup> for knowingly violating provisions of the 1984-85 Milk Diversion Program. On appeal to the Claims Court, the producers lost.<sup>106</sup>

*Durant v. United States*<sup>107</sup> involved farmers alleging breach of contract against ASCS for failure to make feed grain payments under the 1985 price support and production adjustment programs. The plaintiffs lost on the merits.<sup>108</sup>

### 1989

In *Frank's Livestock & Poultry v. United States*,<sup>109</sup> the farmers alleged, among other things, constitutional violations against the United States, which did not state claims for monetary relief. The Claims Court contended it had no jurisdiction over the claims.<sup>110</sup>

*Grav v. United States*<sup>111</sup> was a rare 1989 victory. Cow sellers were granted relief, and the Secretary of Agriculture's decision previously denying sellers' participation in 1984-84 Milk Diversion Program was reversed.<sup>112</sup>

### 1990

In one of five 1990 cases, *Stegall v. United States*,<sup>113</sup> two partnerships sought review of a "one-person" determination regarding the 1986 farm subsidy program. The court denied both parties' motions for summary judgment, and stated that it could not resolve the issues of the case without complete factual findings. The case was remanded to the USDA.<sup>114</sup>

*Abound Corp. v. United States*<sup>115</sup> involved the 1986 and 1987 Price Support and Production Adjustment programs for wheat and feed grains.

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103. 14 Cl. Ct. 390, 394-96 (1988).

104. 14 Cl. Ct. 570, 579 (1988).

105. 15 Cl. Ct. 183 (1988).

106. *Id.* at 192.

107. 16 Cl. Ct. 447 (1988).

108. *Id.* at 453.

109. 17 Cl. Ct. 601 (1989).

110. *Id.* at 607.

111. 886 F.2d 1305 (Fed. Cir. 1989).

112. *Id.* at 1309.

113. 19 Cl. Ct. 765 (1990).

114. *Id.* at 765.

115. No. 739-88C (Cl. Ct. June 22, 1990).

The Government's ruling that plaintiffs adopted a "scheme and device to evade payment limitation regulations" was upheld by the Claims Court.<sup>116</sup>

In *Martin v. United States*,<sup>117</sup> another Dairy Termination Program case, the court upheld the Government's finding of a penalty, declaration of ineligibility to receive compensation, and the requirement that the farmer still adhere to the five-year nonproduction agreement.

*Stevens v. United States*<sup>118</sup> was a Price Support and Production Adjustment Program case. Plaintiffs lost despite various inconsistencies within the administrative record. The Claims Court held that these inconsistencies were allowed by regulation, because DASCO's final decision had a proper basis in the record.<sup>119</sup>

In *Rieschick v. United States*,<sup>120</sup> a Dairy Termination Program case, the Claims Court granted defendant's motion for summary judgment, finding the Government's determination against the farmer to have a rational basis.

It is obvious from this review that few farmers have obtained relief in the Claims Court. The reasons are fourfold: (1) The Claims Court's preference for resolution by summary judgment often vastly reduces the merits of the case to restricted issues of law, to which the court usually gives great deference to the agency's determination of the underlying statute; (2) the Claims Court's view of its limited scope of review — if there is a rational basis, the case stands affirmed — encourages the agency to write final determinations that appear rational even if they result from a denial of due process, an area where the Claims Court has been reluctant to venture; (3) the Claims Court refuses to review due process claims that are not blatantly offensive; and (4) the judges often lack experience in making an APA-type review. Consequently, for the farmer, there are obvious shortcomings to filing suit in the Claims Court. Although it is often quicker (by reason of summary judgment) and cheaper (no disputes over jurisdiction mean less legal fees) than suit in federal court, the results of recent years are not encouraging. In contrast, district court judges appear to be, of late, more pro-farmer and more innovative in their interpretation of ways to fairly adjudicate farmers' claims of denial of due process or other administrative abuses.

### III. CONCLUSION

Obtaining relief in United States Claims Court can be difficult. The authors have represented plaintiffs in numerous cases in United States

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116. *Id.*

117. 20 Cl. Ct. 738 (1990).

118. 21 Cl. Ct. 195 (1990).

119. *Id.* at 202.

120. 21 Cl. Ct. 621 (1990).

Claims Court and district courts throughout the country, and find the latter a preferable venue, even though it may be more costly to the client because of the Government's continuing insistence on litigating jurisdiction.

# Swampbuster: A Report from the Front

ANTHONY N. TURRINI\*

## I. INTRODUCTION

In 1985, Congress took a bold new step in farm legislation by enacting the conservation title<sup>1</sup> of the Food Security Act.<sup>2</sup> Over the past five years, the wetland conservation provisions of that title,<sup>3</sup> known as "swampbuster,"<sup>4</sup> have generated considerable controversy.<sup>5</sup>

Swampbuster seeks to deter wetland drainage by withholding a wide range of agricultural subsidies from farmers who plant commodity crops in wetland basins drained after December 23, 1985.<sup>6</sup> Congress recognized that it is in the public's interest to discourage environmentally destructive farming practices, especially when the country is producing a surplus of commodity crops. In reporting the 1985 farm bill, the House Agriculture Committee concluded that wetlands are a priceless resource which are

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1. Passed into law on the 23rd of December, the conservation title has been described as a "wonderful Christmas present for wildlife agencies." Risley & Budzik, *Implementing Swampbuster and Conservation Easements: An Ohio Perspective*, 43 J. Soil & Water Conservation 33, 33 (1988). The title consists of four basic programs: sodbuster and conservation compliance (subtitle B), swampbuster (subtitle C), and conservation reserve (subtitle D).

2. 16 U.S.C. §§ 3801-3845 (1988). For a discussion of the legislative history, see Malone, *A Historical Essay on the Conservation Provisions of the 1985 Farm Bill: Sod-busting, Swampbusting and the Conservation Reserve*, 34 U. KAN. L. REV. 577 (1986).

3. 16 U.S.C. §§ 3821-3823.

4. Unless otherwise noted, all references to "swampbuster" refer to the statute as originally enacted in the Food Security Act of 1985, Pub. L. No. 99-198, 99 Stat. 1504 (1985) (codified as amended at 16 U.S.C. §§ 3821-3823).

5. In the Midwest, farmers printed signs excluding hunters and other persons from their property, purportedly in response to the unreasonable implementation of swampbuster. One sign read: "Due to the Swampbuster Act of the 1985 Farm Bill, there will be no hunting, trapping or trespassing allowed on these premises. Violators will be prosecuted" (on file with the National Wildlife Federation's Prairie Wetlands Resource Center).

6. 16 U.S.C. § 3821. The statute provides that "any person who in any crop year produces an agricultural commodity on converted wetland shall be ineligible" for certain farm program benefits including price supports, farm storage facility loans, crop insurance, disaster payments, and loans administered by Farmers Home Administration. *Id.*

valuable for wildlife habitat, aquaculture, flood control, water purification, groundwater recharge, and recreation.<sup>7</sup>

The Secretary of Agriculture published final regulations implementing swampbuster in 1987.<sup>8</sup> Within that regulatory scheme, two federal agencies are primarily responsible for administrating swampbuster — the Agricultural Stabilization and Conservation Service (ASCS) and the Soil Conservation Service (SCS).<sup>9</sup> Principal authority for administering and enforcing the law is vested in the ASCS.<sup>10</sup> ASCS county committees make most of the day-to-day decisions concerning program eligibility<sup>11</sup> and grant certain exemptions.<sup>12</sup> Other ASCS employees conduct "spot checks" to ensure swampbuster compliance.<sup>13</sup> The SCS is charged with making the technical determinations<sup>14</sup> in identifying the wetlands subject to swampbuster<sup>15</sup> and in granting exemptions under the "minimal effects" provision.<sup>16</sup> Lesser administrative roles are performed by Farmers Home

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7. H.R. REP. No. 271, 99th Cong., 1st Sess., pt. 1, at 86-87, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 1190-91. The committee succinctly stated the concerns that prompted swampbuster's enactment:

Currently, wetlands are being destroyed at a rate that is environmentally unacceptable . . . [N]early 14.7 million acres of freshwater wetlands and approximately 500,000 acres of saltwater wetlands have been destroyed from the mid-1950s to the mid-1970s.

Much of the wetlands lost in recent years can be attributable [sic] to conversion to agricultural uses. At the present time of surplus agricultural production there is certainly no need for the conversion of more resources into agricultural production especially when those wetlands resources have such inherent value and provide such practical benefits.

*Id.* at 87, *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 1191.

8. 7 C.F.R. §§ 12.1-33 (1990).

9. To help ensure proper administration of swampbuster, Congress appointed the Department of Interior as a "watchdog." Under the statute, the Secretary of Agriculture must consult with the Secretary of Interior concerning the identification of wetlands and determination of exemptions. 16 U.S.C. § 3823. This provision as been interpreted in the final regulations as requiring the ASCS and SCS to consult with the Fish and Wildlife Service on all pending exemption applications and matters relating to the identification of wetlands. 7 C.F.R. §§ 12.6(b)(5), 12.30(c).

10. 7 C.F.R. § 12.6(b).

11. Each crop year, farmers are required to file "AD-1026" forms with their local ASCS office, certifying that they will not produce commodity crops on converted wetlands. *Id.* § 12.7(a)(2). If the county committee determines that a farmer has violated swampbuster, and is not eligible for any type of exemption, it withholds the farmer's subsidies for that year.

12. *Id.* § 12.6(b)(3).

13. *Id.* § 12.6(b)(4).

14. *Id.* § 12.6(c).

15. *Id.* § 12.6(c)(2)(i).

16. *Id.* § 12.6(c)(2)(vi).

Administration,<sup>17</sup> the Federal Crop Insurance Corporation,<sup>18</sup> and the Agricultural Extension Service.<sup>19</sup>

Swampbuster's potential role in protecting wetlands prompted the National Wildlife Federation (NWF) to establish a field office for the purpose of monitoring the law's implementation.<sup>20</sup> NWF suspected that the Department of Agriculture lacked the conviction and expertise to adequately protect wetlands. That perception was fueled by the fact that only two producers in the entire United States had actually lost farm program benefits as a result of swampbuster violations.<sup>21</sup> After two lawsuits, a dozen administrative proceedings, and more than one hundred Freedom of Information Act (FOIA) requests,<sup>22</sup> it is apparent that swampbuster has not been adequately enforced. It is also clear that loopholes in the legislation have limited swampbuster's effectiveness.

## II. SWAMPBUSTER'S SUCCESS IN DETERRING WETLAND DRAINAGE

Before discussing swampbuster's weaknesses, it should be emphasized that the statute has probably succeeded in deterring wetland drainage. During the past 200 years, wetlands were destroyed at a tremendous rate. Of the estimated 215 million acres of wetlands originally found in the contiguous United States, only 99 million acres remained by the mid-1970s.<sup>23</sup> Agricultural practices were responsible for 87% of the wetland loss between the mid-1950s and mid-1970s.<sup>24</sup> In 1985 (the year swampbuster was enacted), the annual rate of wetland conversion was between 300,000 and 450,000 acres per year.<sup>25</sup>

Although there have been no comprehensive studies of wetland drainage subsequent to 1985, both the Environmental Protection Agency<sup>26</sup> and

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17. *Id.* § 12.6(d).

18. *Id.* § 12.6(e).

19. *Id.* § 12.6(f).

20. The National Wildlife Federation is a nonprofit conservation organization dedicated to the wise use and protection of natural resources, including the nation's remaining wetlands. NATIONAL WILDLIFE FEDERATION, 1989 ANNUAL REPORT 5, 8 (1989). NWF opened the Prairie Wetlands Resource Center in March 1987.

21. Personal communication with George Melvin, Chief of the ASCS Compliance Branch (1987).

22. Freedom of Information Act requests were submitted pursuant to 5 U.S.C. § 552 (1988).

23. U.S. FISH AND WILDLIFE SERV., U.S. DEP'T OF INTERIOR, WETLANDS OF THE UNITED STATES: CURRENT STATUS AND RECENT TRENDS 29 (1984).

24. *Id.* at 31.

25. U.S. Dep't of Agric., U.S. Dep't of Agric. Envtl. Assessment for the Wetland Conservation Provisions of the Food Security Act 1985-1 (1986).

26. WILLIAMS, MIAH & FINKBEINER, AERIAL PHOTOGRAPHIC ANALYSIS OF WETLAND CONVERSION RELATED TO THE FOOD SECURITY ACT 11-17 (1990) (prepared for the United States E.P.A.).

the Soil and Water Conservation Society<sup>27</sup> have completed limited studies indicating that the rate has decreased. These findings are supported by the SCS, which recently stated that the annual loss of wetlands during the mid-1980s was between 100,000 and 200,000 acres per year.<sup>28</sup> Nonetheless, many conservation organizations believe the rate of wetland destruction remains unacceptably high.<sup>29</sup>

### III. SWAMPBUSTER'S STATUTORY LIMITATIONS

#### A. *Sanctions*

Swampbuster's principal shortcoming is its failure to penalize farmers for draining or otherwise manipulating a wetland. A violation does not occur unless "commodity crops" are planted in the wetland basin.<sup>30</sup> The cropping requirement substantially diminishes the incentive to preserve wetlands. Farmers can "play the system" by draining wetlands and then planting crops in only those years when commodity prices are high and they do not intend to participate in farm programs.<sup>31</sup> In other years, farmers can plant perennial crops or hay in the converted wetlands without jeopardizing their farm benefits.<sup>32</sup> The cropping requirement also makes it more difficult to detect swampbuster violations. Although the ASCS, SCS, and U.S. Fish and Wildlife Service (FWS)<sup>33</sup> are likely to observe

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27. SOIL AND WATER CONSERVATION SOCIETY, IMPLEMENTING THE CONSERVATION PROVISION OF THE FOOD SECURITY ACT 8-9 (1989).

28. SOIL CONSERVATION SERVICE, INTERPRETATIONS OF WETLAND DATA FROM THE 1987 NAT'L RESOURCE INVENTORY 1 (Aug. 1990).

29. Conservation groups that lobbied for stronger swampbuster provisions in the 1990 farm bill include the Center for Resource Economics, Natural Resources Defense Council, National Audubon Society, National Wildlife Federation, Sierra Club, and Soil and Water Conservation Society. *See Farm Bill 1990: Agenda for the Environment and Consumers* (Island Press 1990).

30. 16 U.S.C. § 3821 (1988). "Commodity crops" are defined as those agricultural commodities "planted and produced in a state by annual tilling of the soil, including tilling by one-trip planters . . . ." *Id.* § 3801(a)(1)(A).

31. The financial benefits of participating in farm programs are generally greater when market prices are low. *See HEIMLICH & LANGNER, SWAMPBUSTING: WETLAND CONVERSION AND FARM PROGRAMS* 8 (1986) (USDA AGRICULTURAL ECONOMIC REP. No. 551).

32. The planting of perennial crops does not require annual tilling, and therefore does not trigger swampbuster sanctions. *See* 16 U.S.C. § 3821(a)(1)(A).

33. In addition to providing technical guidance, the FWS has emerged as the primary investigator of violations. FWS employees typically fly over wetland areas once a year to ensure that conservation easements are not violated. These easement flights often result in the detection of numerous swampbuster violations that are reported to the ASCS. In North Dakota, these practices have earned the FWS the moniker, "spies in the sky."

and report new drainage activity, they simply do not have the resources to perform an annual review of previously manipulated wetlands to determine whether they are planted with commodity crops.

Fortunately for the wetland resource, this loophole was eliminated in the 1990 farm bill.<sup>34</sup> In a major victory for conservationists, swampbuster was amended to make the act of drainage a violation.<sup>35</sup> Farmers who manipulate wetlands are ineligible for subsidies until they restore the affected wetland to its original condition.<sup>36</sup> Swampbuster now provides a real deterrent to drainage, and for the first time creates an incentive to restore converted wetlands.

### B. Scope

A second fundamental limitation of swampbuster, which was not redressed in the new farm bill, is that it pertains only to producers who participate in federal farm programs. Farm operators who do not produce crops with price supports, or who do not rely on federally subsidized loan or insurance programs, can ignore swampbuster altogether. Swampbuster is an effective deterrent only in areas where participation in farm programs is high and where subsidies contribute significantly to farm income or profitability.<sup>37</sup> Fortunately for wetlands (if not the American taxpayer), most producers participate in federal farm programs.<sup>38</sup>

### C. Administrative Appeals

A third weakness of the statute is that it fails to unambiguously provide an administrative appeals avenue for nonfarmers. Swampbuster directed the Secretary of Agriculture to promulgate regulations enabling a "person who is adversely affected by any determination" under the law to seek administrative review.<sup>39</sup> Even though many people may be adversely affected by the drainage of wetlands, the final regulations limit review to farmers who have been or will be denied farm subsidies as a result of a swampbuster determination.<sup>40</sup> Although decisions withholding benefits can be "second-guessed," decisions favoring a producer to the

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34. Food, Agriculture, Conversation, and Trade Act of 1990, Pub. L. No. 101-624, 104 Stat. 3359 [hereinafter 1990 Farm Bill]. With few exceptions, the amendments to swampbuster apply to crop years after 1990.

35. 1990 Farm Bill, Pub. L. No. 101-624, § 1421, 104 Stat. 3359, 3572.

36. *Id.*

37. Heimlich & Langner, *Swampbusting in Perspective*, 41 J. SOIL & WATER CONSERVATION 219, 224 (1986).

38. See J. BOVARD, THE FARM FIASCO 46-47 (1989) (citing U.S. DEPARTMENT OF AGRICULTURE, FARMLINE 5 (1986)). For an economic analysis of swampbuster and its probable effect on farming practices, see Heimlich & Langner, *supra* note 31.

39. 16 U.S.C. § 3843(a) (1988).

40. 7 C.F.R. § 12.12 (1990).

detriment of a wetland cannot be reversed through the formal appeals process. This one-sided procedure has produced skewed results. Seventy-seven percent of all appeals decided by the ASCS favored the farmer.<sup>41</sup> This shortcoming was not remedied in the 1990 farm bill.

#### IV. INADEQUATE IMPLEMENTATION AND ENFORCEMENT

The greatest impediment to swampbuster's effectiveness has been unenthusiastic administration. Virtually everyone agrees that agricultural drainage continues to occur.<sup>42</sup> Although the Department of Agriculture claims that more than \$1 million dollars has been withheld, the most current data indicate that the ASCS has withheld subsidies from only twenty-six farmers throughout the United States.<sup>43</sup> The total amount of farm benefits forfeited was a mere \$124,000.<sup>44</sup> Not a single dollar was withheld from a producer in the Pacific flyway, the gulf coast, or the South.<sup>45</sup> As of

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41. ENVIRONMENTAL LAW INSTITUTE, IMPLEMENTATION OF THE "SWAMPBUSTER" PROVISIONS OF THE FOOD SECURITY ACT OF 1985, at 28 (1990). The problem is exacerbated because farmers dissatisfied with an ASCS determination are offered three bites from the appeals apple. They may request reconsideration of the decision by the county committee. 7 C.F.R. § 780.3. They may appeal the county committee's decision to the state ASCS committee. *Id.* § 780.4. Finally, they may appeal to the ASCS deputy administrator (DASCO) in Washington, D.C. *Id.* § 780.5. Concerned citizens have no right to participate in any of these proceedings.

42. Even the Department of Agriculture acknowledges drainage. After surveying 25% of the farms participating in federal programs, the SCS reported that over 77,000 acres of unexempted wetlands have been converted since 1985. SOIL CONSERVATION SERVICE, FOOD SECURITY ACT PROGRESS REPORT - OCT. 1989 1.

43. Letter from Jay D. Hair, President of NWF, to Clayton Yeutter, Secretary of Agriculture (Oct. 13, 1989) (criticizing Mr. Yeutter's claim that more than \$1 million had been withheld from more than 400 producers) [hereinafter Hair Letter].

44. In January 1989, NWF submitted a FOIA request asking the ASCS for a list of all producers conclusively determined ineligible for agricultural subsidies as a result of swampbuster violations. The ASCS was asked to exclude any producer who was appealing, requesting an exemption, or seeking a wetland redesignation. The agency produced a list that purported to identify all swampbuster violations from December 23, 1985, to April 15, 1989. This information was double-checked by NWF, which contacted the producers, local ASCS committees, or farm bill coordinators from the Fish and Wildlife Service. The study demonstrated that the ASCS's figures were extremely inaccurate and misrepresented the extent of agency enforcement. Confronted with NWF's results, the ASCS suspended its record-keeping practice. The agency promised to publish an updated summary of swampbuster statistics by 1990, but has not yet finalized the report. *Id.*

45. *Id.* During the same time period, the Department of Agriculture gave more than \$90 billion (full dollars) to American farmers in the form of federal subsidies. FEDERAL ASSISTANCE AWARD DATA SYSTEM, U.S. DEPARTMENT OF AGRICULTURE, CCC FEDERAL ASSISTANCE FY 1982-1989: SUMMARY BY STATE (1989).

46. Hair Letter, *supra* note 43. Wetlands in these areas provide critical breeding and wintering habitat for waterfowl, and are threatened by agriculture, industry, and other

April 1989, only six states had ever withheld agricultural subsidies as a result of swampbuster violations.<sup>46</sup>

#### *A. ASCS County Committees*

Lax enforcement is largely due to the organizational structure of the ASCS.<sup>47</sup> The primary responsibility for implementing swampbuster is in the hands of locally elected county committees, which frequently misconstrue, misapply, or ignore swampbuster in order to excuse farmers for wetland drainage. A wetland conservation analysis team made up of experts from the ASCS, SCS, FmHA, FWS, and the Environmental Protection Agency specifically found that ASCS county committees are reluctant to withhold farm program benefits.<sup>48</sup> The interagency team concluded that the purposes of swampbuster would be best achieved by replacing the committees with interagency review boards.<sup>49</sup>

The county committees' failure to fully enforce swampbuster is the result of several factors. First, the ASCS is institutionally biased — its original and primary function is to supervise the distribution of federal subsidies to farmers,<sup>50</sup> not to regulate environmental transgressors. ASCS employees are trained to administer farm programs and are more knowledgeable about agriculture than environmental protection. Naturally, they tend to sympathize with the concerns of their traditional constituency, the farm community. County committees are reluctant to penalize farmers for the sake of "newfangled" environmental ideals.

Second, committee members are sometimes personally biased. To be eligible to become a committee member, an individual must be a resident

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land uses. *See U.S. FISH AND WILDLIFE SERVICE/CANADIAN WILDLIFE SERVICE, WATERFOWL FOR THE FUTURE: THE NORTH AMERICAN WATERFOWL MANAGEMENT PLAN* (1987). The Pacific flyway is one of four north-south migratory routes used by waterfowl in North America. *See Ducks Unlimited, Ducks Unlimited in Your Flyway* (1986).

46. Hair Letter, *supra* note 43. Those states are Indiana, Minnesota, New York, Pennsylvania, South Dakota, and Wisconsin.

47. Keith Bjerke, ASCS Administrator, characterizes this criticism of the local committees as "a bunch of bunk." According to Mr. Bjerke, "This American system of ours says that, No. 1, you are innocent until proven guilty. No. 2, you should be tried by a jury of your peers, not outside agitators. What is going on is best judged by local folks rather than outsiders." Brisbane, *A Farm Belt Fight Over Protected 'Potholes'*, *Washington Post*, Dec. 6, 1989, at A3.

48. Memorandum from Mike Hein, Chairman of the Wetland Conservation Analysis Team, to John B. Campbell, Deputy Under Secretary of the Department of Agriculture (Nov. 28, 1989) (discussing wetland protection and restoration recommendations for the Conservation Title of the 1990 Farm Bill) (available at the Prairie Wetlands Resource Center).

49. *Id.*

50. For an overview of the structure and function of the ASCS, see C. KELLEY & J. HARBISON, *A LAWYER'S GUIDE TO ASCS ADMINISTRATIVE APPEALS AND JUDICIAL REVIEW OF ASCS DECISIONS* 4-18 (1990).

farmer of the county in which she is to serve.<sup>51</sup> Only farmers living in the county are entitled to vote in committee elections.<sup>52</sup> This arrangement, which asks members of the regulated community to enforce swampbuster, disfavors objective decision-making. County committees are hesitant to take actions that may harm friends or neighbors.

Third, ASCS personnel lack technical expertise in wetland issues. They receive little or no formal training enabling them to recognize wetlands or to determine the scope and effect of drainage systems. Nevertheless, it is the ASCS that is responsible for spot checking farms to ensure swampbuster compliance.<sup>53</sup>

Finally, committee members have little professional or financial incentive to enforce laws or regulations with which they disagree. Committee membership is a part-time position. The full-time farmers who sit on the committees are sometimes more concerned with maintaining their standing in the agricultural community than they are with losing a part-time job and a nominal pay check.

### *B. Exemptions*

Exemptions have been the most widely abused provisions of swampbuster. The Department of Agriculture currently grants five different exemptions which allow farmers to convert wetlands to cropland and continue receiving agricultural subsidies. The exemptions are known as the "commenced determination,"<sup>54</sup> "hardship exemption,"<sup>55</sup> "third party exemption,"<sup>56</sup> "good faith reliance exemption,"<sup>57</sup> and "minimal effects exemption."<sup>58</sup>

1. *Commenced Determinations.*—The exemption most frequently used to justify wetland drainage is the "commenced determination." Swampbuster provides that a producer who plants crops on a converted wetland remains eligible for agricultural subsidies if the conversion was begun prior to the enactment of the Food Security Act on December 23, 1985.<sup>59</sup> As of April 1989, the ASCS had received 5,259 requests for commenced determinations and granted 78% of the requests considered.<sup>60</sup> Many of

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51. 7 C.F.R. § 7.15 (1990).

52. *Id.* § 7.4.

53. *Id.* § 12.6(b)(4).

54. See *infra* notes 59-75 and accompanying text.

55. See *infra* notes 76-83 and accompanying text.

56. 7 C.F.R. § 12.5(d)(vi) (1990).

57. See *infra* notes 84-97 and accompanying text.

58. See *infra* notes 98-112 and accompanying text.

59. 16 U.S.C. § 3822(a)(1) (1988).

60. AGRICULTURAL STABILIZATION AND CONSERVATION SERVICE, SOD/SWAMP CUMULATIVE DATA REPORT FOR APRIL AND MARCH (1989).

the exemptions approved by the ASCS were not justified by swampbuster or its regulations.<sup>61</sup>

In a recently completed study, the Government Accounting Office (GAO) concluded that the ASCS frequently issued commenced determinations without appropriate documentation.<sup>62</sup> The GAO examined twenty-three approved commenced determination requests and found that in nine cases (39%), farmers had failed to submit evidence sufficient to justify an exemption.<sup>63</sup>

One particularly egregious commenced determination moved NWF to sue the ASCS in April 1989.<sup>64</sup> The action was the first legal challenge to the ASCS's administration of swampbuster. NWF sought to reverse an agency decision to exempt 6,500 acres of prairie wetlands in Bottineau County, North Dakota. A county drainage district had requested a commenced determination for a project known as the White Spur/Stone Creek drainage project.<sup>65</sup> Although none of the prerequisites to a commenced determination was met,<sup>66</sup> an accommodating county committee exempted every wetland in the 139-square mile assessment area.<sup>67</sup> The district court dismissed the action for want of standing,<sup>68</sup> finding that

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61. The Environmental Law Institute characterizes the issuance of commenced determinations as "problematic," noting that the ASCS often grants the exemption even if the literal requirements of the regulations are not met. ENVIRONMENTAL LAW INSTITUTE, *supra* note 41, at 33.

According to the Soil and Water Conservation Society, "there seems little doubt that county committees were lenient in granting commenced determinations." SOIL & WATER CONSERVATION SOCIETY, *supra* note 27, at 42.

62. GENERAL ACCOUNTING OFFICE, FARM PROGRAMS: CONSERVATION COMPLIANCE PROVISIONS COULD BE MADE MORE EFFECTIVE 32-33 (1990).

63. *Id.*

64. *National Wildlife Fed'n v. Agricultural Stabilization & Conservation Serv.*, No. A4-89-067 (D.N.D. 1989). NWF's state affiliate, the North Dakota Wildlife Federation, is a co-plaintiff in the suit.

65. To obtain a commenced determination, a drainage district must establish, *inter alia*, that before December 23, 1985, it "started installation of the drainage measures, or legally committed substantial funds toward the conversion of wetlands by entering into a contract for the installation of [drainage measures] . . . or by purchasing construction supplies and materials for the primary and direct purpose of converting wetland." 7 C.F.R. § 12.5(d)(4)(ii) (1990).

66. The contract for the White Spur/Stone Creek drainage project was not executed until September 1988. Construction and the purchase of construction materials began after that date.

67. Letter from Ronald Deraas, Bottineau County ASCS Executive Director, to Clifford Issendorf, Chairman of the Bottineau County Water Resource District (Sept. 29, 1988) (Exhibit 1 to amended Complaint in *National Wildlife Federation*, No. A4-89-067).

68. *National Wildlife Federation*, No. A4-89-067, Memorandum and Order (Aug. 21, 1989).

NWF's members would not suffer an "injury in fact"<sup>69</sup> and that the injury was speculative.<sup>70</sup> The court also suggested that any injury threatening NWF or its members was outside the zone of interest protected by swampbuster.<sup>71</sup>

On appeal, the Eighth Circuit reversed the district court's dismissal.<sup>72</sup> In holding that NWF had standing to sue, the court made three principal findings. First, the injuries alleged by NWF — a reduction in soil moisture, adverse effects on water purity, and the destruction of wildlife habitat — are more than identifiable trifles; they are statements of specific harm that will be experienced by ascertainable individuals.<sup>73</sup> Second, the link between the wrongful issuance of a commenced determination and injury resulting from wetland drainage is not too speculative to support standing.<sup>74</sup> Third, landowners participating in farm programs are not the only individuals within the zone of interests the statute seeks to protect: "The Swampbuster provisions, on their face, establish the goal of decreasing the conversion of private wetland into cropland in order to help preserve, for the Nation and its citizens, the beneficial attributes of wetlands."<sup>75</sup>

Although the court did not decide the merits of the case, the Eighth Circuit's decision concerning the threshold issue of standing has important implications. Allowing nonfarmers to sue the ASCS injects some accountability into the administration of swampbuster. It is now clear that "outsiders" have a legitimate interest in farm programs and the environmental effects of agricultural subsidies. The decision also serves notice to drainage districts and other drainers that questionable swampbuster exemptions cannot always be relied upon. Persons who intend to convert wetlands must consider the cost of litigation and the possibility of having invalid exemptions reversed by a federal court.

2. *Hardship Exemptions*.—A related, but separate, exemption allows DASCO to grant a commenced determination to an otherwise ineligible producer upon a showing that "undue economic hardship will result

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69. *Id.* slip op. at 4. The court concluded that only those persons directly affected by the ASCS's decision (the drainage district and the landowners) would suffer injury sufficient to support standing.

70. The court noted that "landowners may not decide to drain wetlands on their property regardless of the exemption." *Id.*

71. *Id.* In effect, the district court ruled that environmental organizations and other concerned citizens could never obtain judicial review of improper swampbuster exemptions.

72. *National Wildlife Fed'n v. Agricultural Stabilization & Conservation Serv.*, 901 F.2d 673 (8th Cir. 1990).

73. *Id.* at 677.

74. *Id.* at 677-78.

75. *Id.* at 678.

because of substantial financial obligations incurred prior to December 23, 1985, for the primary and direct purpose of converting the wetland.”<sup>76</sup> During NWF’s lawsuit, the ASCS changed its rationale for exempting the White Spur/Stone Creek drainage project. The agency maintained that the commenced determination was “arguably” justified, but that the more “appropriate” basis on which to decide the case was the so-called “hardship” provision.<sup>77</sup> This mid-litigation turnabout was the first occasion on which the ASCS granted “hardship” relief.<sup>78</sup> The agency has since used the provision to exempt other large, politically popular drainage projects.<sup>79</sup>

NWF amended its complaint to address the ASCS’s new theory. In addition to arguing that the hardship exemption was arbitrary and capricious,<sup>80</sup> NWF alleged that the ASCS violated the National Environmental Policy Act (NEPA)<sup>81</sup> by failing to prepare an environmental impact statement (EIS).<sup>82</sup> Many swampbuster exemptions are ministerial in the sense that farmers meeting certain criteria are entitled to an exemption. In the Eighth Circuit, ministerial decisions are not subject to NEPA.<sup>83</sup> The hardship exemption, however, involves a discretionary act on the part of the ASCS — the agency must weigh the hardship of the landowners if an exemption is denied, against the environmental damage if it is granted. In other words, the ASCS must determine whether economic

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76. 7 C.F.R. § 12.5(d)(5)(iv) (1990).

77. Letter from Keith Bjerke, ASCS Administrator, to Murray Sagsveen, attorney for the Bottineau County Water Resource District (Aug. 1, 1989) (Exhibit 3 to amended complaint in *National Wildlife Federation*, No. A4-89-067) [hereinafter Bjerke Letter].

78. Some commentators have questioned the ASCS’s authority to grant hardship exemptions. See ENVIRONMENTAL LAW INSTITUTE, *supra* note 41, at 34 n.39.

79. In North Dakota, hardship relief was granted to the Heimdal drainage project, Oak Creek drainage project, Wells County Drain #1, and Crystal Lake Drain #6. Each of these projects had previously been denied commenced determinations for all or a portion of the proposed drainage. Letter from Keith Bjerke to the Wells County [North Dakota] Water Resource District Board (Sept. 25, 1989).

80. The ASCS found that \$65,000 was spent before December 23, 1985. The agency justified its decision by noting that the drainage district and landowners would be deprived the benefit of their investment if hardship relief were denied. The ASCS did not determine that any particular person would suffer financial hardship as a result of that expenditure. Bjerke Letter, *supra* note 77.

81. 42 U.S.C. §§ 4321-4370a (1988).

82. Under NEPA, federal agencies are required to prepare and circulate for public and interagency comment a detailed draft and final environmental impact statement for major federal actions significantly affecting the quality of the human environment. *Id.* § 4332(2)(C).

83. See, e.g., *Goos v. I.C.C.*, 911 F.2d 1283, 1296 (8th Cir. 1990) (holding that the Interstate Commerce Commission’s issuance of a certificate permitting the conversion of a railroad corridor to a recreational trail was ministerial, and that a NEPA review was therefore unnecessary).

hardship is, in fact, "undue." This is precisely the sort of discretionary decision in which a NEPA review is appropriate. The ASCS should consider the environmental consequences of its actions and the alternatives to environmentally harmful hardship exemptions. The preparation of an EIS would help ensure that the ASCS does not use its equitable authority thoughtlessly or for improper purposes.

3. *Good Faith Reliance Provision.*—Although the commenced determination has been the most frequently misused section of swampbuster during the past five years, a regulation known as the "good faith reliance" provision<sup>84</sup> threatens to undermine the statute in future years. The rule enables the ASCS to make price support payments to producers who innocently and reasonably violate the terms of an ASCS farm program while relying on the misrepresentations of a county or state ASCS committee.<sup>85</sup> This provision, promulgated twenty years before the passage of swampbuster, was adopted by reference when the Department of Agriculture published the final swampbuster regulations.<sup>86</sup>

In April 1989, the ASCS relied on this rule to exempt eighty-five acres of wetlands in Yellow Medicine County, Minnesota.<sup>87</sup> The Minnesota State ASCS committee had previously granted the Yellow Medicine River Watershed District a commenced determination for a project known as Ditch 18. The ASCS Administrator found that the exemption was improper and reversed the decision, but decided to treat wetlands drained in the

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84. 7 C.F.R. § 790.2 (1990).

85. The regulation states:

(a) Notwithstanding any other provision of law, performance rendered in good faith in reliance upon action or advice of any authorized representative of a county committee or State committee as defined in Part 719 of this chapter, may be accepted . . . as meeting the requirements of the applicable program, and price support may be extended or payment may be made therefor in accordance with such action or advice to the extent it is deemed desirable in order to provide fair and equitable treatment.

(b) The provisions of this part shall be applicable only if a producer relied upon action or advice of a county or State committee or an authorized representative of such committee in rendering performance which the producer believed in good faith met the requirements of the applicable program. The authority provided in this part does not extend to cases where the producer knew or had sufficient reason to know that the action or advice of the committee or its authorized representative upon which he relied was improper or erroneous, or where the producer acted in reliance on his own misunderstanding or misinterpretation of program provisions, notices or advice.

*Id.*

86. See 7 C.F.R. § 12.11 (1990).

87. Letter from Vern Neppl, Acting ASCS Administrator, to Kevin Stroup, attorney for Ditch 18 petitioners (Apr. 14, 1989).

interim as if they were exempt from swampbuster. NWF and several other plaintiffs<sup>88</sup> contested the ASCS's decision in federal district court.<sup>89</sup>

Plaintiffs argued that the ASCS lacked authority to invent administrative exemptions. Swampbuster creates an almost absolute prohibition against public subsidization of wetland conversion: "Except as provided in section 3822 of this title and notwithstanding any other provision of law, following December 23, 1985, any person who in any crop year produces an agricultural commodity on converted wetland shall be ineligible" for certain farm program subsidies.<sup>90</sup> As the statute unambiguously states, the only exceptions to the general rule are found in the "Exemptions" section.<sup>91</sup> That section does not establish an exemption for farmers who rely on erroneous ASCS advice, nor does it authorize the ASCS to create additional exemptions.

Plaintiffs also contended that it was arbitrary and capricious for the ASCS to grant equitable relief under the circumstances of the case. The good faith reliance provision is applicable only when a producer reasonably relies on the misrepresentations of the ASCS and believes in good faith that her actions comply with the requirements of an ASCS farm program.<sup>92</sup> The administrative record showed that project proponents chose to drain wetlands knowing the commenced determination might be invalid and that the ASCS was reviewing the exemption.<sup>93</sup>

In September 1990, the district court granted the ASCS's cross-motion for summary judgment and dismissed the case.<sup>94</sup> The court found a rational basis for the ASCS's conclusion that the "project was practically completed before petitioners were notified of the action rescinding the state committee's determination."<sup>95</sup> The district court did not address

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88. The other plaintiffs are the Minnesota Conservation Federation, the Izaak Walton League of America, and Leon Carney.

89. *National Wildlife Fed'n v. Agricultural Stabilization & Conservation Serv.*, No. 3-89-674 (D. Minn. filed Oct. 11, 1989).

90. 16 U.S.C. § 3821 (1988).

91. *Id.* § 3822.

92. 7 C.F.R. § 790.2(b) (1990).

93. The "smoking gun" was a letter from the attorney for the project petitioners advising his clients that an ASCS official had questioned the validity of the commenced determination. He specifically warned the petitioners of the danger of proceeding without additional assurances from the ASCS. Letter from Kevin Stroup to All Ditch 18 Petitioners (Apr. 25, 1988) (available at the Prairie Wetlands Resource Center).

94. *National Wildlife Federation*, No. 3-89-674, Order (Sept. 5, 1990).

95. *Id.* at 3. Plaintiffs did not dispute that wetlands were drained prior to the reversal of the commenced determination. Rather, plaintiffs questioned whether the drainage district was legally justified in proceeding with construction under the circumstances of the case. As the Department of Agriculture clearly foresaw when it published 7 C.F.R. § 790.2, there is a difference between reliance and reasonable reliance.

plaintiffs' argument that the agency exceeded its statutory authority. The district court's order is currently on appeal to the Eighth Circuit.<sup>96</sup>

Whatever the outcome, this action will likely establish a significant precedent. In response to increasing criticism of its administration of swampbuster, the ASCS recently conducted a nationwide review of exemption decisions. The ASCS examined 986 commenced determinations that were granted without consultation with the FWS. The agency found that 556 exemptions (56%) were improperly approved.<sup>97</sup> However, the ASCS has not decided whether to reverse the exemptions outright, or to treat the affected wetlands as if they were exempt under the good faith reliance provision. Presumably, the Eighth Circuit's opinion will weigh heavily in the decision-making process.

4. *Minimal Effects Exemptions.*—The SCS, rather than the ASCS, has regulatory authority over a fourth and often controversial swampbuster exemption. The statute provides that the Secretary of Agriculture may exempt a producer "for any action associated with the production of an agricultural commodity on converted wetland if the effect of such action, individually and in connection with all other similar actions authorized by the Secretary in the area, on the hydrological and biological aspect of wetland is minimal."<sup>98</sup> The Secretary delegated the administration of the "minimal effects" exemption to the SCS,<sup>99</sup> which has granted the exemption with relative restraint.<sup>100</sup> Nevertheless, attempts have been made to liberalize the minimal effects provision to accommodate agricultural drainage. Thus far, the most ambitious effort has occurred in North Dakota.

In 1987, North Dakota passed a drainage law protecting a farmer's ability to remove water from her land while affording some protection to wetlands.<sup>101</sup> The statute permits a farmer to convert any wetland to

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96. *National Wildlife Fed'n v. Agricultural Stabilization and Conservation Serv.*, No. 90-5483MN (8th Cir. filed Sept. 21, 1990).

97. *AGRICULTURAL STABILIZATION AND CONSERVATION SERVICE, REPORTS ON COMMENCED DETERMINATIONS: NOTICE CP-373* (1990).

98. 16 U.S.C. § 3822 (1988).

99. 7 C.F.R. § 12.6(c)(2)(vi) (1990).

100. As of October 1989, the SCS had granted only 171 minimal effects exemptions affecting fewer than 3,000 wetland acres. *SOIL CONSERVATION SERVICE, supra* note 42.

101. The law, inappropriately called the "North Dakota no-net-loss" law, is found at N.D. CENT. CODE §§ 61-32-01 to -11 (Supp. 1989). A policy statement reveals the priorities of the legislature:

The legislative assembly finds that agriculture is the most important industry in North Dakota and that agricultural concerns must be accommodated in the protection of wetlands. Wetlands can be a hindrance to farming practices. Even though property taxes are generally paid on such lands, wetlands provide limited economic return to the landowner. Wetland policies can obstruct water development and water management projects, and can affect other developments.

*Id.* § 61-32-01.

cropland, but requires mitigation in some circumstances.<sup>102</sup> In practice, private drainage is recorded as a debit in the state wetland bank, and restoration projects of the government or nonprofit organizations such as Ducks Unlimited are counted as mitigation. The drainer is required to pay only 10% of the estimated mitigation costs.<sup>103</sup> In November 1989, the North Dakota State Engineer's Office and the state office of the SCS agreed to use the minimal effects exemption in conjunction with the state drainage law.<sup>104</sup> In brief, they agreed that farmers who convert wetlands to cropland would be able to obtain a minimal effects exemption by using restored wetlands in the state wetland bank as mitigation.

NWF promptly criticized the arrangement as unlawful, and threatened to sue the SCS.<sup>105</sup> NWF observed that there is little legal support for such an expansive interpretation of the minimal effects exemption.<sup>106</sup> Neither the legislation nor the final rules suggest that mitigation can be used to compensate for drainage that has more than a minimal effect on wetlands. NWF also argued that the agreement was inconsistent with a sound public policy.<sup>107</sup> Swampbuster was intended to prevent wetland drainage and to reduce the nation's surplus of agricultural commodities.<sup>108</sup> Allowing private parties to convert wetlands to cropland and use publicly funded restoration projects as mitigation undermines both purposes. In

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102. The mitigation requirement applies only to wetlands with a watershed area exceeding 80 acres. *Id.* § 61-32-03.

103. *Id.* § 61-32-04(4).

104. SOIL CONSERVATION SERVICE, NATIONAL FOOD SECURITY ACT MANUAL pt. 512, amend. ND13 (1989).

105. The FWS also responded to the agreement, but its reaction was mixed. Region 6 of the FWS, which includes North Dakota, defended the generous use of minimal effects exemptions. Regional Director, Galen Buterbaugh, suggested it was in the best interest of the resource to work with farmers and permit drainage that "landowners believe is necessary for their farming operations." Letter from Galen Buterbaugh, Regional Director, to John Turner, Director of the FWS (Mar. 16, 1990). A less pacific Region 3 "adamantly opposed" the agreement and warned it would establish an "extremely dangerous precedent." Letter from James Gritman, Regional Director, to John Turner, Director of the FWS (Mar. 8, 1990).

106. Letter from Jay Hair, President of NWF, to Wilson Scaling, Chief of the SCS (Mar. 26, 1990). In the preamble to the final rules, the Department of Agriculture specifically rejected the proposal that mitigation be used routinely to justify minimal effects determinations: "[T]he rule has not been changed to allow the production of agricultural commodities on converted wetland to be exempted categorically through the mitigation of the loss of fish and wildlife values." The Department acknowledged that mitigation might be appropriate in "limited" circumstances, but emphasized that "the legislative intent for the minimal effect determination is that it should rarely be used." Preamble to the Highly Erodible Land and Wetland Conservation Final Regulations, 7 C.F.R. pt. 12 (1990).

107. Letter from Jay Hair, *supra* note 106.

108. See 7 C.F.R. § 12.1.

essence, it requires the taxpayer to subsidize private drainage, then pay for its mitigation.

In a victory for conservationists, the SCS rescinded the agreement after two meetings involving state and federal officials and other concerned parties.<sup>109</sup> The SCS also established "sideboards" limiting the circumstances in which credits in a wetland bank can be used to justify a minimal effects exemption.<sup>110</sup> Notably, these sideboards became the basis for amendments to the minimal effects exemption in the 1990 farm bill. The exemption now allows farmers to drain wetlands if they restore wetlands of comparable size and ecological value.<sup>111</sup> The new provision is subject to certain conditions that are expected to limit the number of exemptions requested. For instance, only frequently cropped wetlands are eligible to be drained, the restored wetland must be in the same general area of the local watershed as the converted wetland and must be protected by easement, and the restoration cannot be financed by the federal government.<sup>112</sup>

### *C. Wetland Delineations*

Although most critics of swamplbuster implementation have focused on exemptions, improper delineations pose a far greater threat to the nation's wetland base.<sup>113</sup> The alarming consequences of "overlooking" wetlands are best illustrated by recent events in Kansas.

In early 1990, the Kansas Department of Wildlife and Parks (DWP) discovered that the SCS had identified only three wetlands in a seven-county area of southwest Kansas.<sup>114</sup> These counties are part of the playa lakes region, an area known to contain tens of thousands of temporary and seasonal wetlands.<sup>115</sup> The DWP was skeptical of the SCS's inventory,

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109. Letter from Wilson Scaling, Chief of the SCS, to Ronnie Clark, North Dakota State Conservationist (Apr. 25, 1990).

110. *Id.*

111. Pub. L. No. 101-624, § 1422, 104 Stat. 3359 (1990).

112. *Id.*

113. The SCS is responsible for identifying wetland areas subject to swamplbuster. 7 C.F.R. § 12.6(c) (1990). For example, the SCS must conduct a wetland inventory before a farmer may receive federal subsidies. *Id.* § 12.7(a).

114. The counties are Stevens, Morton, Hamilton, Stanton, Gray, Kearny, and Seward. Letter from Charles Lee, Kansas Dept. of Wildlife & Parks, to Tony Turrini (July 23, 1990).

115. Playas are shallow, circular depressions formed during the Pleistocene by wind erosion. They have been described as "islands of wildlife habitat in a sea of intensive agriculture." U.S. FISH AND WILDLIFE SERVICE, U.S. DEPARTMENT OF THE INTERIOR, PLAYA LAKES REGION WATERFOWL HABITAT CONCEPTION PLAN: CATEGORY 24 OF THE NORTH AMERICAN WATERFOWL MANAGEMENT PLAN 1 (1988). The playa lakes region includes portions of Texas, Kansas, New Mexico, Oklahoma, and Colorado. *Id.* at 3.

especially because the FWS reported 5,846 wetland basins in those same counties.<sup>116</sup> Despite the DWP's repeated requests, the state office of the SCS refused to redo its wetland inventory.<sup>117</sup>

In September 1990, the SCS elevated the issue to its national office in response to NWF's criticism of the wetland inventory and a FOIA request submitted in anticipation of litigation.<sup>118</sup> The agency assembled a national review team to conduct a field investigation of wetland determinations in southwest Kansas. After reviewing several counties, the team concluded that the concerns of NWF and the DWP were well founded.<sup>119</sup> State SCS personnel had committed several chronic errors during the inventory process, and wetlands had indeed been grossly underestimated. The national review team recommended, *inter alia*, that wetland mapping conventions be revised to account for the unique characteristics of playa wetlands, that the state SCS office redelineate wetlands in southwest Kansas and any other part of the state where similar inventory errors were made, and that the DWP and FWS be fully involved in future efforts to delineate wetlands.<sup>120</sup> The SCS has since adopted the recommendations of the review team.<sup>121</sup>

Although the agency finally took measures to correct the mistakes of its state office, the situation underscores the danger of misidentification. If the DWP had not monitored the activities of the SCS and then insisted on a redetermination, tens of thousands of acres of wetlands would have been improperly excluded from the protection of swampbuster. Moreover, there is a very real possibility that this was not an isolated incident. The review team concluded that errors in Kansas occurred because the national

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116. Memorandum from Charles Lee to Tony Turrini (Sept. 19, 1990) (interpreting U.S. FISH AND WILDLIFE SERVICE, U.S. DEPARTMENT OF THE INTERIOR, NATIONAL WETLANDS INVENTORY (1987) (draft inventory maps)).

117. Letter from James Habiger, Kansas State Conservationist, to Joel Kramer, Chief of the Fisheries and Wildlife Division, Kansas Department of Wildlife and Parks (Apr. 10, 1990).

118. The request sought all records pertaining to wetland delineations in southwest Kansas, with particular emphasis on documents describing the conventions and methodologies used by the SCS to identify wetlands. Letter from Anthony Turrini, counsel to NWF's Prairie Wetlands Resource Center, to R. Mack Gray, Acting Chief of the SCS (Aug. 30, 1990).

119. Report from the National Review Team to R. Mack Gray, Acting Chief of the Soil Conservation Service (undated) [hereinafter Report from National Review Team]. After watching ducks flush from a "nonexistent" playa, an exasperated team leader stated: "When I see standing water, waterfowl use and wetland plants, I have to think that these are wetlands." Comment of Billy Teels, SCS National Biologist (Sept. 25, 1990).

120. Report from National Review Team, *supra* note 119.

121. Personal communication from Gerald Root, Acting Director of the SCS Conservation Planning Division (Nov. 30, 1990).

and state offices provided inadequate training and guidance.<sup>122</sup> The implication is that the same defect may have tainted wetland delineations in other parts of the country.

It should be noted that the SCS's acknowledgement of delineation problems does not insure that Kansas playas are protected by swamplibster. The 1990 farm bill provides that "No person shall be adversely affected because of having taken an action based on a previous [wetland] determination by the Secretary."<sup>123</sup> The legislative history suggests that producers who drain wetlands while reasonably relying on improper wetland delineations may be exempt from swamplibster.<sup>124</sup>

## V. CONCLUSION

In 1985, environmentalists heralded swamplibster as an innovative and much-needed effort to protect the nation's dwindling wetland base. That enthusiasm waned as it became apparent that the Department of Agriculture was either unwilling or unable to vigorously enforce the law. We now have a new farm bill and a significantly amended swamplibster. Overall, the wetland conservation provisions are probably stronger than their predecessors, but are also more complicated, subjective, and technical. The result is that the Department of Agriculture will exercise far greater discretion than before. For the first time, it will evaluate the "good faith" of violators,<sup>125</sup> impose graduated penalties,<sup>126</sup> and approve mitigation efforts.<sup>127</sup> The amendments to swamplibster will provide new opportunities for administrative abuse. It is up to concerned citizens — and the courts — to persuade the Department of Agriculture that a strong, effective swamplibster is in society's best interest.

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122. Report from National Wetlands Review Team, *supra* note 119.

123. Pub. L. No. 101-624, § 1422, 104 Stat. 3359, 3573 (1990).

124. H.R. CON. REP. No. 916, 101st Cong., 2d Sess. 911, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS 4656, 5436.

125. Under certain circumstances, a person who converts a wetland "in good faith and without the intent to violate the provisions of [swamplibster]" will be eligible for a reduced penalty. Pub. L. No. 101-624, § 1422, 104 Stat. 3359 (1990).

126. If the Secretary of Agriculture determines that a swamplibster violator is eligible for a graduated sanction, she will "reduce by not less than \$750 nor more than \$10,000, depending on the seriousness of the violation, program benefits" the violator would otherwise be entitled to receive. *Id.* Under the former law, a violation resulted in the loss of all farm program benefits, regardless of the blameworthiness of the violator or the magnitude of the infraction. 16 U.S.C. § 3821 (1988). Critics of swamplibster referred to this provision as the "drop dead" penalty.

127. Pub. L. No. 101-624, § 1422, 104 Stat. 3359 (1990).

# Protecting Agricultural Resources in Europe: A Report from the Netherlands

WIM BRUSSAARD\*

## I. INTRODUCTION

The countries of Western Europe, and especially the Member-States of the European Community, are all more or less in the same position concerning the protection of agricultural resources. The amount of agricultural land is limited and continues to diminish through conversion to other uses, especially urbanization, industrialization, and infrastructure developments. The use of the remaining agricultural land is confronted with a variety of limitations, some the result of natural circumstances. Other interests, such as the value of nature and landscape and availability for recreational use, are playing an increasing role or getting recognition in that same rural area. Additionally, in the last twenty years another concern is increasingly winning importance in our agricultural area: the condition of the environment. More and more agriculture is the cause *and* the victim of serious environmental problems. This complicated situation has given rise to several measures, both on a national level and on the level of the European Community.

Agricultural resources in the Netherlands also stand under heavy pressure. Although the Netherlands is, after the USA and France, third in exports of agricultural products,<sup>1</sup> the area of agricultural land is limited: 2 million hectares (half of the total Dutch area) are cultivated land.<sup>2</sup> As a result of Holland's high population density, the Dutch countryside is a place of much competition between conflicting interests such as urbanization and industrialization, infrastructure developments, outdoor recreation, nature conservation and — of course — agriculture. During the 1970s, the annual loss of farmland to other purposes was about 10,000 hectares, during the last decade the loss slowed to approximately 5,000 hectares.<sup>3</sup>

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1. *LANDBOUW-ECONOMISCH BERICHT* (Den Haag, Landbouw-Economisch Instituut, Periodieke Rapportage 1-86 (1986)), at 14.

2. *MINISTRY OF AGRICULTURE AND FISHERIES, DUTCH AGRICULTURE IN FACTS AND FIGURES* 3 (1986). A hectare is approximately equal to 2.469 acres.

3. A. CRIJNS, *THE REGULATIVE PHASE OF LAND DEVELOPMENT* 1 (Landinrichtingsdienst Information Paper 7, 1986).

This Article first will survey the Dutch legal-administrative land-use structure. Since 1924, the Dutch have enacted legislation to encourage agricultural development of rural areas financed by the government and to ensure that the agrarian productivity conditions are optimal. In large parts of rural Holland, agrarian activity is closely interwoven with nature and landscape. In 1985, new legislation made possible the development of rural areas for agricultural as well as other purposes.<sup>4</sup> That legislation closely connected development to physical planning policy.<sup>5</sup>

In line with the government's policy concerning rural areas, the government tries to ensure that in certain vulnerable areas, farmers adjust their farming practices to the needs of nature and landscape. This Article also discusses governmental land management schemes such as financial subsidies.<sup>6</sup>

Strong agricultural productivity has a negative side too. The production of certain products created substantial surpluses. One of the measures the European Commission took was to stimulate farmers to "set aside" parts of their arable land for nonagricultural purposes. These issues will be dealt with in the third section of this Article.<sup>7</sup>

Agricultural developments can also become a danger for the environment. One of the most threatening problems the Dutch now must address is a gigantic surplus of manure from the Dutch livestock industry. This causes serious pollution of soil, water, and air. The government was forced to introduce strong measures to fight this problem and to keep agrarian land productive in the long run. Section III B of this Article discusses this bizarre problem.<sup>8</sup>

## II. THE DUTCH LEGAL-ADMINISTRATIVE LAND USE STRUCTURE

### A. *Physical Planning Policy*

The high population density of the relatively small area of the Netherlands has, for a long time, required optimal use of the limited land. Thus, the Dutch have adopted stringent measures to control the allocation of land for different purposes. They have a comprehensive system of physical planning.<sup>9</sup> This physical planning is described as "the

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4. See *infra* notes 19-35 and accompanying text.

5. See *infra* notes 9-18 and accompanying text.

6. See *infra* notes 36-50 and accompanying text.

7. See *infra* notes 52-60 and accompanying text.

8. See *infra* notes 61-100 and accompanying text.

9. See generally W. BRUSSAARD, THE RULES OF PHYSICAL PLANNING 1986, Ministry of Housing, Physical Planning and Environment, The Hague, The Netherlands (1987); PLANNING LAW IN WESTERN EUROPE 216-45 (J.F. Garner & N.P. Gravells eds 1986); R.

search for and the establishment of the best possible mutual adaptation of space and society.”<sup>10</sup> Physical planning policy is a concern of the three levels of government: central government, the twelve provinces, and some 650 municipalities.

Because the Netherlands is a decentralized unitary state, each level of government is free to conduct its own policy and to promulgate its own regulations, provided that it does not conflict with the policy or regulations of a higher authority. Physical planning is based on the Physical Planning Act.<sup>11</sup>

At the national level, the government's policy on physical planning is expressed in the Government Reports on Physical Planning, which contains the main outlines and principles of national spatial policy, and the Structural Outline Plans (*Structuurschema's*), which contain outlines and principles that are generally important for national spatial policy but directed to a specific sector of that policy, for instance Land Development. Both Reports and Plans are adopted according to the procedure for national physical planning key decisions, which is a special procedure used for particularly important spatial decisions on the national level.<sup>12</sup>

At the provincial level, the Regional Plans (*streekplannen*) outline in general terms the future development for the province. A Regional Plan is meant to steer the provincial planning process; it guides the province's own policy and is used as a guideline for the approval of municipal land-use plans. Outside the direct field of physical planning, the Regional Plan provides the basis for the assessment of Land Development Plans or Programs.<sup>13</sup>

The municipal level has two spatial plan models: the Structure Plan, indicating the future development of the municipal area,<sup>14</sup> and the Land-use Plan (*bestemmingsplan*), prescribing the use of land in the plan area. The Land-use Plan is the most important because it directly binds the citizen. A Land-use Plan is mandatory for rural areas. The plan indicates

HELD & D. VISSER, RURAL LAND USES AND PLANNING: A COMPARATIVE STUDY OF THE NETHERLANDS AND THE UNITED STATES (1984); Grossman & Brussaard, *Planning, Development, and Management; Three Steps in the Legal Protection of Dutch Agricultural Land*, 28 WASHBURN L.J. 86-149 (1988) [hereinafter Grossman & Brussaard, *Planning, Development, and Management*].

10. Derde nota over de ruimtelijke ordening, deel 1a: Oriënteringsnota (Orientation Report) Tweede Kamer, 1973-1974, 12 757, nr. 2, at 19.

11. Wet op de Ruimtelijke Ordening (Stb. 1962, 286), amended in 1985 (Stb. 1985, 623-625), *reprinted in* Schuurman & Jordens 64 (1986).

12. Wet op de Ruimtelijke Ordening, arts. 2a-2c.

13. *See infra* notes 19-35 and accompanying text.

14. Wet op de Ruimtelijke Ordening, art. 7.

the appropriate use or designation (*bestemming*) of the land involved.<sup>15</sup> Dutch law prohibits changing the use of the land to a function inconsistent with this designation, and building and construction permits must be refused in case of conflict with the Land-use Plan.<sup>16</sup> Thus, land designated for agricultural use is protected from conversion to nonagricultural uses. Land may be compulsorily purchased on the basis of the Land-use Plan.<sup>17</sup> The plan requires approval by the Provincial Government.<sup>18</sup>

### B. Land Development

For decades, the focus of attention was on improving the agrarian productivity conditions. Since 1924, the Netherlands have had legislation to encourage agricultural development of rural areas financed by the government.<sup>19</sup> But in large parts of rural Holland, agrarian activity is closely interwoven with nature and landscape. This legislation also has diminished the aesthetic value of the land. This situation was acknowledged in the 1970s when new legislation was framed recognizing both agricultural and nonagricultural claims on land in rural areas, especially nature and landscape values and outdoor recreation. This new legislation, known as the Land Development Act (*Landinrichtingswet*), was enacted in 1985.<sup>20</sup>

In this Act, physical planning policy is accepted as a guideline for land development decisions.<sup>21</sup> This is formulated in article 4 of the Land Development Act: "Land development strives toward the improvement of the countryside in conformity with the functions of that area, as they are specified in the framework of physical planning." Land development (*landinrichting*) involves a complicated legal scheme and a high level of government involvement in landownership and use.<sup>22</sup> Because

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15. *Id.* at art. 10.

16. *Id.* at art. 44; *Woningwet* (Housing Act, Stb. 1962, 287), latest version *reprinted in Schuurman & Jordens 19-I* (1986), art. 48.

17. *Onteigeningswet* (Compulsory Purchase Act, Stb. 1851, 125), latest version *reprinted in Schuurman & Jordens 24* (1988), art. 77, lid 1.

18. *Wet op de Ruimtelijke Ordening*, art. 28.

19. See Dam, *De doelstelling van de ruilverkaveling in de ruilverkavelingswetgeving* 11, in VAKGROEP AGRARISCH RECHT, *LANDBOUWUNIVERSITEIT, WAGENGEN, RECHT IN ONTWIKKELING* (1986); Steiner, *Farmland Protection in the Netherlands*, 36 J. SOIL AND WATER CONSERVATION 71 (1981).

20. *Landinrichtingswet* (Stb. 1985, 299), *reprinted in Schuurman & Jordens 101* (1986).

21. See generally Brussaard, *De Landinrichtingswet in relatie tot de ruimtelijke ordening*, 66 STEDEBOUW EN VOLKSHUISVESTING 527-532 (1985).

22. See THE LAND DEVELOPMENT ACT - AN OUTLINE, GOVERNMENT SERVICE FOR LAND AND WATER USE (1988); Grossman & Brussaard, *The Land Shuffle; Reallocation of Agricultural Land under the Land Development Law in the Netherlands*, 18 CAL. W. INT'L L.J. 209-289 (1988).

the Land Development Act is designed to accommodate varied interests, different land development approaches and decisionmaking processes are required. Thus, the law includes four statutory types of land development:

1. Consolidation (*ruilverkaveling*), modeled after methods long used in the Netherlands and other West European countries, is intended for areas where agriculture is the primary function and other functions such as recreation are less important. It usually involves reallocation of land in the entire area. The decision to proceed with a consolidation requires the approval of a majority of the landowners or users.<sup>23</sup>
2. Redevelopment (*herinrichting*) is a new method and is intended for areas in which important nonagricultural functions must coexist with agriculture. This method is appropriate for areas within the urban sphere of influence or with important nature and landscape values. Reallocation of land will normally occur in a redevelopment area, but redevelopment can also proceed without reallocation.<sup>24</sup>
3. Adaptation (*aanpassingsinrichting*) is also new and is derived from West German legislation (*Flurbereinigungsgesetz*). It is designed to be used in conjunction with an infrastructural improvement or development (a road or a canal) to modify the unfavorable land-use effects of that project.<sup>25</sup>
4. Consolidation by agreement (*ruilverkaveling bij overeenkomst*), the oldest method of consolidation, regulates a procedure by which three or more landowners voluntarily exchange land to achieve better parcelling.<sup>26</sup>

The choice between consolidation and redevelopment is especially difficult, and is closely related to physical planning policy. Therefore, the Structural Outline Plan for Land Development provides general guidelines for that choice.<sup>27</sup>

The decisionmaking about land development involves a complicated and time-consuming procedure, which can take between ten and twenty years. This procedure is initiated with a written request to the Minister of Agriculture, Nature Management and Fisheries, submitted by a government or other public body, an eligible organization, or a group of

23. Landinrichtingswet, art. 15.

24. *Id.* at art. 14.

25. *Id.* at art. 16.

26. *Id.* at art. 17.

27. The Structural Outline Plan for Land Development (*Structuurschema Landinrichting*) contains the main principles governing national land development policy and provides special insight into the spatial aspects of that policy. Landinrichtingswet, art. 6. The plan is adopted in accordance with the procedure for national physical planning key decisions. *See supra* note 12.

landowners and users.<sup>28</sup> If the land development is consistent with the land development and physical planning policy, and if land development in the area is desirable, the Minister places the area on the List of Land Development Projects in Preparation (*Voorbereidingsschema Landinrichting*).<sup>29</sup> A local land development commission is appointed, which is responsible for the preparation and implementation of the land development project.<sup>30</sup>

The local commission prepares a Land Development Plan that serves as the basis for a decision as well as the guide for implementing the project.<sup>31</sup> In areas where problems are complex and especially where nonagricultural functions are significant, a rather general Land Development Program is first prepared upon which the decision is based, followed by a Plan that guides the implementation.<sup>32</sup> After several opportunities for public comment, the provincial government makes a decision about establishing the Plan in relation to the provincial physical planning policy. Then, too, the choice between consolidation or redevelopment is made.<sup>33</sup> A choice of consolidation requires approval of a majority of the number of votes calculated by either the number of landowners and tenants or of the amount of ground surface represented in the election.<sup>34</sup>

After this decision, the rather lengthy process of implementation begins. The land brought into the project is appraised; roads, waterways, and other infrastructural facilities are improved or constructed; land is acquired for public purposes and reallocated. Owners and users have a right either to receive the same amount and quality of land that they brought into the project, or be compensated. After the reparceling, the structure and the rights of the owners are established in the Reallocation Plan.<sup>35</sup>

### *C. Management Agreements*

Rural areas in the Netherlands must fulfill various purposes. Therefore, Dutch land-use policy distinguishes between situations involving

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28. Landinrichtingswet, art. 23. A group of landowners and users must represent at least 30% of the ground involved.

29. *Id.* at art. 18. The List of Land Development Projects in Preparation indicates areas for which consolidation or redevelopment projects are in preparation. The list is amended annually on recommendation of the provincial governments. The provincial states also recommend the appropriate type of land development and preferred method of preparation. See *infra* note 31 and 32; Landinrichtingswet, art. 19.

30. Landinrichtingswet, at art. 27.

31. *Id.* at arts. 73-93. This is the so-called simplified preparation.

32. *Id.* at arts. 33-45. This is the so-called phased preparation.

33. *Id.* at arts. 46 and 51.

34. *Id.* at art. 52.

35. *Id.* at arts. 124-220.

integration and separation of land-uses.<sup>36</sup> Integration is particularly relevant for agricultural land with special landscape or natural values, that is some 500,000 to 700,000 hectares (1/4 to 1/3 of all cultivated land in the Netherlands). Characteristic of these areas is the direct connection between the natural conditions and the farming situation. On one hand, existing landscape and nature values are threatened there by agricultural developments; on the other hand, those values can only exist together with certain forms of agrarian land-use.<sup>37</sup>

In 1975, the Dutch government introduced in the Relationship Report (*Relatienota*), a policy program for specialized agricultural land management.<sup>38</sup> The report distinguishes two types of areas:

1. Management areas: areas where maintaining the present nature and landscape values is just as important as continuing the agricultural use and production. In these areas, integration of land-use functions is the goal. Therefore, farmers are offered the opportunity to enter voluntary contractual management agreements (*beheersovereenkomsten*), under which they will receive financial compensation for adapting their farming practices to the requirements of nature and landscape preservation.

2. Reserve areas: areas where the values of nature and landscape are so high that effective agricultural production will be impossible in the long run. The goal in this area is to end farming entirely by purchasing the land. Farmers cannot be forced to sell, but if farmers offer their land for sale, the government has an obligation to purchase.<sup>39</sup> In the meantime, farmers in reserve areas have the opportunity to enter transitional management agreements.

Thus, the *Relatienota* policy has two goals: the maintenance and development of nature and landscape values in the most vulnerable

36. Vierde Nota over de ruimtelijke ordening, beleidsvoornemen, Tweede Kamer, 1987-1988, 20 490, nrs. 1-2, at 68-70.

37. Brussaard & Van Wijmen, *Natuur en landbouw: enkele juridisch-bestuurlijke beschouwingen over scheiding en verweving*, 46 AGRARISCH RECHT 157 (1986); Dauvillier, *Achtergronden en perspectieven van het beleid voor de landelijke gebieden*, in *VERWEVING IN HET LANDELIJK GEBIED* 5-6 (Rijksplanologische Dienst, publikatie 85-4 (1985)).

38. Nota betreffende de relatie tussen landbouw en natuur- en landschapsbehoud; Tweede Kamer, 1974-1975, 13 285, nrs. 1-2 (1975). This *Relatienota* focuses on the relationship of agriculture with nature and landscape conservation.

See generally Grossman, *Management Agreements in Dutch Agricultural Law: The Contractual Integration of Agriculture and Conservation*, 16 DENVER J. INT'L LAW AND POL'Y 95 (1988); Grossman & Brussaard, *Planning, Development, and Management*, *supra* note 9, at IV.

39. Regeling beheersovereenkomsten 1988, Ministerie van Landbouw en Visserij, Nr. J 7433 (Stcr. 1988, 149) [hereinafter Regeling 1988]. The *Bureau Beheer Landbouwgronden* (Bureau for Agricultural Land Management) is in charge of purchasing the land, and of concluding management agreements with farmers.

agrarian cultural landscapes by adaptation of agricultural management, and the financial subsidization of farmers who carry out the farm business in those areas. This policy is limited to a number of geographically defined regions of particular value and vulnerability (up to 200,000 hectares). The instruments to carry out this policy are embodied in the Decree on Management Agreements,<sup>40</sup> which also contains the Dutch translation of the EC program for farming in less-favored areas.<sup>41</sup>

For every province the Minister of Agriculture, Nature Management and Fisheries has indicated the number of hectares to which the *Relatienota* policy will apply.<sup>42</sup> It then becomes the provincial government's responsibility to establish the area boundaries, indicate which areas are management areas and which are reserve areas, and establish a management plan for each area. This plan indicates the range of possible practices (actions to be taken or to be omitted in the area) and the corresponding compensations.<sup>43</sup> In every management area there is a limited number of packets of management provisions, depending on the management goals for that area (for instance maintenance of natural handicaps, protection of nearby nature reserves, botanical management, meadowbird management, migratory bird management, or maintenance of landscape).<sup>44</sup>

Once the management plan for an area is established, farmers can enter into management agreements.<sup>45</sup> Such an agreement is a private contract between an individual farmer and the government. A management agreement lists the packet of specific management treatments — measures to be taken and activities to be avoided — to which the farmer is obligated, and the compensation he will receive. In exchange, participating farmers may only choose from the management packets indicated in the plan.<sup>46</sup> The government is not obligated to contract for parcels that would not further the management goals.<sup>47</sup> A management agreement is normally entered into for a duration of six years, and is presumed to be renewed for the next six-year period unless a party gives notice before the end of the period.<sup>48</sup> Although the government's right to end the agreement is limited, the farmer may end an agreement after a trial period of one year.<sup>49</sup>

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40. *Id.*

41. Directive 75/268/EEC on mountain and hill farming and farming in less-favored areas.

42. Regeling 1988, *supra* note 39, art. 8.

43. *Id.* arts. at 9-18.

44. *Id.* at bijlage 1A.

45. *Id.* at art. 22.

46. *Id.* at art. 24.

47. *Id.* at art. 26.

48. *Id.* at arts. 39 and 42.

49. *Id.* at art. 43.

The implementation of management agreements had a very slow start. The procedure for establishing the management plans was lengthy, and farmers were reluctant to enter management agreements. By June 30, 1990, however, management plans were operational for 150 areas, covering some 57,400 hectares, and 2,500 farmers had entered management agreements, covering some 15,600 hectares.<sup>50</sup>

### III. PROTECTING AGRICULTURAL RESOURCES IN THE NETHERLANDS: DEALING WITH PRESENT-DAY PROBLEMS

The strong agrarian productivity conditions resulting from national legislation and the Common Agricultural Policy of the European Economic Community also procure some negative results. In various sectors of agriculture, substantial surpluses have been created now. This led the European Community to take limiting measures with regard to cereals, sugar-beets, and milk.<sup>51</sup> At the same time, the Community encourages farmers to "set aside" parts of their arable land for nonagricultural purposes.

#### A. *Set Aside Regulations*

The "set aside" regulations of the Community<sup>52</sup> are intended to stimulate farmers to take arable land out of production, while maintaining the agricultural productivity of that land. The regulation is applicable to land on which crops are cultivated for which a European market regulation exists. If farmers meet certain criteria, they may require financial compensation. In the Dutch translation of this regulation,<sup>53</sup> the

50. EVALUATIEVERSLAG BEHEERSREGELINGEN 1989, publicatie nr. 33 Directie beheer landbouwgronden, Utrecht 1990; information ir. J. Boelen, Directie beheer landbouwgronden.

51. The Superlevy on milk, for example, based on EC-Council Regulation No. 856/84, seeks to fix the amount of milk delivered from farms in the Community to the amount delivered in 1983 minus a fixed percentage. If milk is delivered above this reference quantity (the milk quota), a levy must be paid (the Superlevy). This is nearly as high as the price of milk. This system was developed to balance supply and demand of milk. Delivery of milk without a levy is only possible for producers if a quota is registered in their name. This EC-regulation was translated by all the Member-States of the Community into national legislation. It has led to much distinction about the interpretation of the decree, much bureaucracy, and a lively trade in milk quotas.

See Walda, *The Legal Status of Agro-Industrial Enterprises and Their Relation with Landowners and Agricultural Workers*, Netherlands report to the 13th International Congress of Comparative Law, Montreal 1990, T.M.C. Asser Instituut - The Hague, 171-185 (1990).

52. EC Council Regulation No. 1094/88

53. Beschikking ter zake van het uit produktie nemen van bouwland, Nr. J 88/8620 (Stcrt. 1988, 158).

farmer who wants to receive these subsidies must be younger than sixty-five years old and is obliged to keep the land out of production for five years.<sup>54</sup> He may choose three possible measures:<sup>55</sup>

- laying fallow his land, with a possibility of crop rotation;
- afforesting; or
- using the land for nonagricultural purposes.

A farmer choosing the option of laying fallow has several obligations. He is not allowed to use organic waste matter or animal manure, and only the insecticides, pesticides, and herbicides approved by the minister of Agriculture are allowed. Furthermore, the land must be cultivated with "green manure" (that is, a conservation cover crop) like clover or marigolds. This green manure may not be removed from the land or used for animal feed or commercial purposes. It is to be ploughed under at the end of the set-aside period or, if the land is taken into use again for crop rotation, within that period.<sup>56</sup>

In case of afforestation, the land must be afforested with quick-growing trees.<sup>57</sup> Although the explanatory note to the regulation assumes that afforesting land is an agricultural activity, the designation of land uses in a land-use plan is actually a municipal activity. Certain areas in northern Holland are characteristic for their treeless and open landscape. The farmers in these areas are already in trouble because of sinking prices. Should they decide to afforest their land, it is possible that municipal physical planning regulations would prevent them from doing so.

If the farmer agrees to use his land for nonagricultural purposes, the third possibility the regulation offers, he is not allowed to use his land for the production of any form of vegetable or animal products.<sup>58</sup> The compensation the farmer receives for setting aside his land is 700 ECU (European Currency Unit) per hectare per year when laying fallow or afforesting, and 300 ECU in the case of nonagricultural use.<sup>59</sup> The set aside regulation is meant to diminish surplus production by diminishing the amount of productive land. Because it is relatively new, its effectiveness is difficult to determine. However, expectations are high.<sup>60</sup>

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54. *Id.* at arts. 3 and 4.

55. *Id.* at art. 6.

56. *Id.* at art. 7.

57. *Id.* at art. 8.

58. *Id.* at art. 9.

59. *Id.* at art. 14. The compensation was raised from 600 ECU to 700 ECU on December 8, 1989. 1 ECU is the approximate equivalent of \$1.50 as of January 1991. For an explanation of ECU conversion see D. WYATT & A. DASHWOOD, THE SUBSTANTIVE LAW OF THE EEC 34-35 (1987).

60. In May 1990, set-aside agreements were entered for an area of nearly 8,500 hectares. Structuurnota Landbouw, regeringsbeslissing, Tweede Kamer, 1989-1990, 21 148, nrs. 2-3, at 145.

### B. *Manure Legislation*

Until now, the main interest of the European Community in the field of agriculture has been handling the surplus situations. Environmental issues, however, are receiving more emphasis in European policy. Since the 1987 amendments of the European Treaty, the protection of the environment has become an explicit goal of the European Community.<sup>61</sup> The coming years will likely see new regulations regarding the protection of soil and water. These regulations are particularly important because agriculture has become an important cause and victim of pollution. This is illustrated by another surplus product that the Netherlands, Denmark, and parts of West-Germany have to deal with: a surplus of animal manure. This section will concentrate on the Dutch experience and legislation.

1. *Content of the Dutch Manure Legislation.*—In recent years, there have been regular alarming reports of serious contamination of soil and groundwater by nitrogen and of the large-scale depletion of forests due to ammonia. The most important cause of this pollution is the gigantic quantity of animal manure produced by the livestock industry. In past decades, the livestock industry has grown significantly as a result of mechanization, economies of scale, intensified use of land, and especially the wholesale import of livestock feed through the harbour of Rotterdam. These developments have helped the livestock industry make an important contribution to the Dutch economy. The large surplus of manure resulting from this development exists not only in regions where the livestock industry is concentrated, but also on a national scale. At present, the annual production of animal manure in the Netherlands is more than ninety million tons. For years, livestock farmers have been spreading most of this manure on their own land or in the immediate surroundings. This has often resulted in an overdosing, sometimes extreme, of the minerals (nitrogen, phosphate, and potassium) and heavy metals (copper, cadmium, and zinc) found in the manure. This overdosing causes serious harm to the agricultural sector and the environment, such as decline in soil fertility, decrease in crop quality, health hazards for livestock, decline

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61. With the Single European Act (Pb. 1987, L 169) a new title "Environment" was added to the EC-Treaty. Article 130 R provides, among other things, that action by the Community relating to the environment shall have the following objectives: to preserve, protect and improve the quality of the environment; to contribute towards protecting human health; to ensure a prudent and rational utilization of natural resources. According to art. 130 T, protective measures of the Community shall not prevent any Member State from maintaining or introducing more stringent protective measures compatible with the Treaty.

in quality of groundwater, deposition of potentially acidifying substances, and stench nuisance.<sup>62</sup>

To identify the problem, a new word was introduced in Dutch politics: "manuring" (*vermesting*). Manuring is considered one of the most important focal points of environmental policy. Moreover, in a relatively short time, the manure problem has engendered an entirely new system of legislation and regulation.<sup>63</sup> This system became effective in 1987, far too late according to environmentalists, and much too abruptly according to farmers.

This manure regulation encompasses two laws. The Soil Protection Act<sup>64</sup> applies, among other things, to the use of animal manure, and the Fertilizer Act<sup>65</sup> regulates trade in fertilizing products, removal of surplus manure, and the production of animal manure. Government decrees and ministerial regulations have elaborated on the subject matter of these two Acts. Initially, the legislation applied to manure produced by cattle, pigs, chickens, and turkeys because these animal types produce by far the greatest part of the total animal manure in the Netherlands.<sup>66</sup> The Minister of Agriculture has the power to bring other types of livestock and poultry under the force of the law. The minister has announced that beginning in 1991, the manure regulations will also be applicable to ducks, rabbits, and fur-bearing animals.<sup>67</sup>

In attacking the manure surplus, the first problem facing the legislators was to determine a standard for measuring the amount of manure. The solution chosen was to measure the quantity of phosphate found in the manure, because phosphate is one of the polluting substances. Thus, the minister established the quantity of phosphate that the average animal produces per year in its manure.<sup>68</sup> The next schedule gives an impression of the detail of this system. Research yielded a phosphate quantity for each of the animals originally covered by the regulation.

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62. Besluit gebruik dierlijke meststoffen (tb. 1987, 114), *reprinted in* Schuurman & Jordens 191 (1987), at 15-66, Nota van toelichting, at 7 [hereinafter Besluit gebruik dierlijke meststoffen].

63. See generally Brussaard & Grossman, *Legislation to Abate Pollution from Manure: The Dutch Approach*, 15 N.C.J. INT'L L. AND COM. REG. 85-114 (1990).

64. Wet bodembescherming (Stb. 1986, 374), *reprinted in* Schuurman & Jordens 147-VIb (1986) [hereinafter Wet bodembescherming].

65. Meststoffenwet (Stb. 1986, 592), *reprinted in* Schuurman & Jordens 191 (1987) [hereinafter Meststoffenwet].

66. Regeling aanwijzing diersoorten en hun mestproduktie (Stcrt. 1986, 246), *reprinted in* Schuurman & Jordens 191 (1987), at 84-98.

67. Mestbeleid tweede fase, *infra* note 87, at 8-9.

68. Regeling aanwijzing diersoorten en hun mestproduktie, *supra* note 66, at art. 2 and bijlage 1. See also Regeling vaststelling hoeveelheid fosfaat per 1000 kg dierlijke meststof (Stcrt. 1987, 81), *reprinted in* Schuurman & Jordens 191 (1987), at 166-172.

*Proportion animals - phosphate (examples):*

		kg phosphate/ animal/year	number of animals at 125 kg phosphate/ year
<b>CATTLE:</b>			
milk cow		41	3
female calf	younger than 1 year	9	14
	older than 1 year	18	7
bull kept for breeding	younger than 1 year	12	10
	older than 1 year	22	6
<b>PIGS:</b>			
breeding sow	from 25 kg till 7 months	7,1	18
	7 months till first service	11,8	11
	25 kg till first service	8,2	15
slaughter sow		11,8	11
meat pigs		7,4	17
<b>SLAUGHTER CHICKEN</b>		0,24	521
<b>SLAUGHTER TURKEY</b>		0,79	151

Because of the close relation between the type of feed consumed by an animal and the composition of the manure produced by the animal, it is possible to influence the phosphate level of the manure through the composition of the feed. Therefore, the regulation was amended in early 1990 so that lower phosphate standards are permitted when phosphorous-poor feed is used. This encourages environmentally sound manure production.<sup>69</sup>

The next step in the system of manure legislation is to relate these phosphate standards to areas of agricultural land. The *application* of animal manure is regulated by a government decree based on the Soil Protection Act.<sup>70</sup> This decree establishes standards for the maximum quantities of manure (expressed in kilograms of phosphate) that may be applied on agricultural land per hectare per year. Because the extent to which phosphate is absorbed from the soil can differ with various

69. Wijziging Regeling aanwijzing diersoorten en hun mestproduktie (Stcr. 1989, 253).

70. Besluit gebruik dierlijke meststoffen, *supra* note 62.

crops, a distinction has been made between grassland, fodder cropland (such as land on which corn is cultivated) and arable land. These standards will be implemented in a number of phases because implementation of a final standard on short notice would have led to an enormous manure surplus and serious problems for the livestock industry.<sup>71</sup>

#### APPLICATION OF ANIMAL MANURE — MAXIMUM STANDARDS

(kg. phosphate/hectare/year)

Time period	Grassland	Fodder cropland	Arable land
1 May 87-1 Jan. 91	250	350	125
1 Jan. 91-1 Jan. 95	200	250	125
1 Jan. 95-	175*	175*	125*
From 2000*	Final	Final	Final

\* Approximate

For the first and the second phases, the government has already established the standards.<sup>72</sup> The third and final phase standards will be established more specifically depending on further developments.

With much resentment on the side of the environmentalists, the norms have been selected in such a way that in the first phase there was no *national* manure surplus. But in the second phase there will be a considerable national surplus, which can be applied neither on one's own farm nor elsewhere in the country. The frantic search for technical solutions for this surplus continues.

The decree includes rules that allow fewer phosphates to be applied on phosphate-saturated ground, and more on ground with low phosphate levels.<sup>73</sup> An inventory of phosphate-saturated grounds that has been drawn up recently indicates that in large parts of the Netherlands, most grounds are already saturated with phosphate.<sup>74</sup>

The use of animal manure in fall and winter carries the extra risks of nitrogen and phosphate leaching into the soil and running off to groundwater or surface water. During these periods, the crops take up little or no nitrogen while, simultaneously, there is a surplus of precipitation. Therefore, the manure legislation includes provisions restricting manure spreading during those periods.

To alleviate the evaporation of ammonia that may occur when manure is applied, the regulation also contains a provision about incorporating

71. See *id.* *Nota van toelichting*, at 9.

72. *Id.* at arts. 2 and 3.

73. *Id.* at arts. 9 and 10.

74. See *infra* text accompanying notes 93 and 94.

spread manure into the soil. Phased implementation has been selected for these rules as well. At present, only the first phase (through 1990) has been regulated. Currently, it is forbidden to spread animal manure on grassland in October and November, and on snow covered ground from January 1 through February 15.<sup>75</sup> The Dutch government recently decided that it is unacceptable to have the evaporation prevention measures result in the pollution being pushed off to other components of the environment, especially the soil. Therefore, when systems of manure application with a low ammonia emission will be implemented, the prohibition of spreading manure will be extended at the same time.<sup>76</sup>

With respect to the *production* of animal manure, the maximum quantity of manure (expressed in kilograms of phosphate) that can be produced on a farm is directly related to the amount of agricultural land comprising that farm. Here, too, an elaborate and detailed system of regulations exists. The primary regulation is that manure production up to 125 kilograms of phosphate per hectare per year is permitted; manure producing above that limit is forbidden.<sup>77</sup> Under this rule, manure producers were obliged to submit data on the number of animals on the farm, the quantity of their manure production, and the area of agricultural land belonging to the farm at the time the Fertilizer Act came into force.<sup>78</sup> In addition, producers of animal manure are required to keep manure records updated.<sup>79</sup> If the farm's manure production exceeds the quantity of phosphate that may be applied on the land of that farm, the producer must pay a levy on the surplus.<sup>80</sup> The transfer of manure production to another farm business or to another location is restricted.<sup>81</sup>

The efficient transport of surplus manure is also regulated by the Fertilizer Act.<sup>82</sup> In addition to the record keeping on manure applicable to the producers, dealers in animal manure and managers of storage places and processing facilities are also required to keep records up to date.<sup>83</sup> Furthermore, the sale of animal manure must always be accom-

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75. Besluit gebruik dierlijke meststoffen, *supra* note 62, at art. 8.

76. See *infra* text accompanying note 95.

77. Meststoffenwet, *supra* note 65, at art. 14.

78. *Id.* at art. 6; Registratiebesluit dierlijke meststoffen (Stb. 1986, 625), *reprinted in* Schuurman & Jordens 191 (1987), at 100-109.

79. Besluit mestbank en mestboekhouding (Meststoffenwet) (Stb. 1987, 170), *reprinted in* Schuurman & Jordens 191 (1987), at 111-122.

80. Meststoffenwet, *supra* note 65, at art. 13, lid 4.

81. *Id.* at art. 15; Verplaatsingsbesluit Meststoffenwet (Stb. 1987, 171), *reprinted in* Schuurman & Jordens 191 (1987), at 125-135.

82. Meststoffenwet, *supra* note 65, at arts. 5-12.

83. Besluit mestbank en mestboekhouding, *supra* note 79, at art. 3.

panied by proofs of delivery. These proofs must be sent to the Manure Bank.<sup>84</sup>

The Manure Bank ensures the efficient transfer of excess manure. The Bank is designated to supervise observance of the manure book-keeping provisions. It is charged with accepting surplus and mediating trade in excess manure. The Bank is obligated to accept the quantities of manure offered by manure producers.<sup>85</sup>

2. *Transition to the Second Phase.*—On January 1, 1991, the first phase of the manure legislation ended and the second phase, with stricter standards, began. In 1990, the efficacy of the legislation was evaluated,<sup>86</sup> and on account of this evaluation the Minister of Agriculture announced new measures.<sup>87</sup>

As the evaluation shows, manure production in the Netherlands has been decreasing since 1985, both in the amount of manure and in the amount of phosphate. Simultaneously, the manure surplus increased at the level of the individual farm business because of the introduction of the phosphate standards in 1987. The same response will occur in 1991 when the new standards are effective.<sup>88</sup>

The number of animals to which the manure legislation is applicable (cattle, pigs, chickens, and turkeys) has also been decreasing.<sup>89</sup> At the same time, however, there was a considerable increase of animals of the types that do not (yet) come under the terms of the law: sheep, goats, ducks, rabbits, fur-bearing animals (such as minks and foxes), and horses.<sup>90</sup> In light of this development, the minister decided to bring ducks, rabbits and fur-bearing animals under the force of the law in the second phase. Another system of regulation will be introduced for horses, goats, and sheep. For these animals, maximum numbers per hectare will be applicable.<sup>91</sup>

As to the phosphate-saturated grounds, research has indicated that in the areas where the livestock industry is concentrated (the eastern and southern parts of the Netherlands) 270,000 hectares are saturated, according to the standards of the Decree on Application of Animal

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84. *Id.* at art. 8.

85. Meststoffenwet, *supra* note 65, art. 9.

86. Evaluatiestaat mestbeleid eerste fase, Tweede Kamer, 1989-1990, 21 502, nrs. 1-2 [hereinafter *Mestbeleid eerste fase*].

87. Notitie mestbeleid tweede fase, Tweede Kamer, 1989-1990, 21 502, nr. 3 [hereinafter *Mestbeleid tweede fase*].

88. *Mestbeleid eerste fase*, *supra* note 86, at 65.

89. For cattle this decrease has been caused by the introduction of the Superlevy (see *supra* note 51) in 1984. *Mestbeleid eerste fase*, *supra* note 86, at 26.

90. *Mestbeleid eerste fase*, *supra* note 86, at 29.

91. *Mestbeleid tweede fase*, *supra* note 87, at 8-9.

Manure.<sup>92</sup> Sixty percent of all agricultural land in those concentration areas is saturated, which is much more than was expected. Without preventive measures, saturation areas will expand to an area of 300,000 hectares by the year 2000. If the rules of the Decree on Application of Animal Manure would be applied to this total area (meaning lower standards for manure application on these grounds), a considerable extra manure surplus on the level of farm businesses would exist.<sup>93</sup> Therefore, the Minister decided to limit the designation of phosphate-saturated areas in 1991/1992 to the 60,000 to 80,000 hectares where the risk of phosphate leaching is the highest. At the same time, the standards for manure application on fodder cropland will become stricter more rapidly adjusting to: 200 kilograms phosphate per hectare in 1993, 150 kilograms in 1994, and 125 kilograms in 1995. These standards are applied because the highest quantities of manure are often applied on these fodder croplands, and so the risk of phosphate saturation is the highest there.<sup>94</sup>

The prohibition against spreading manure will be extended. At the end of the second phase (1995) the spreading prohibition will last at least five months (September 1 - February 1). This rule forces farmers to maintain storage facilities for manure for a minimum period of six months including a period for bridging bad weather conditions. If those storage facilities are not realized in 1994, the spreading prohibition will be extended through February.<sup>95</sup>

In addition to these measures, the Minister counts on less phosphate in animal feed, more distribution to areas with a shortage of manure, and more processing facilities for animal manure and export of the products.

Also, with respect to the production of animal manure, new measures will be necessary in the second phase. A new regulation concerning the transfer of manure production to another farm business or to another location is in preparation. According to this regulation, a reduction of thirty percent will be applied when manure production rights are transferred. No transfer will be permitted to areas with a manure surplus.<sup>96</sup>

To cope with the manure problem in the second phase, a manure processing capacity of six million tons at the end of 1994 will be necessary. The minister considers this to be the function of the livestock industry. Therefore, a new levy on manure production will be introduced.<sup>97</sup> Beginning in 1995 no more manure may be produced than can be applied

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92. Besluit gebruik dierlijke meststoffen, *supra* note 62, at art. 9.

93. Mestbeleid eerste fase, *supra* note 86, at 12.

94. Mestbeleid tweede fase, *supra* note 87, at 9-10.

95. *Id.* at 15-16.

96. *Id.* at 11-12.

97. *Id.* at 13.

(in conformity with the application standards) on one's own farm or can be disposed of by means of agreements with other users or with manure processing factories. If a farmer cannot prove beforehand that he can meet these requirements, his manure-producing rights will be suspended.<sup>98</sup>

On the whole, the Minister is satisfied with the results of the first phase because the volume of the manure production has stabilized. The Dutch livestock industry has become accustomed to the manure legislation.<sup>99</sup> Interestingly, acceptance of this legislation by farmers is rather high.<sup>100</sup> Nevertheless, the proposed measures for the second phase result in the same tension between the interests of the livestock industry and the need for environmental protections, which was so characteristic in the first phase. For instance, tension exists in the difference between 270,000 hectares of ground actually phosphate-saturated and the 60,000 to 80,000 hectares the minister will designate as phosphate-saturated in the next years. Also, the new measures will mean that the manure problem will spread to other parts of the Netherlands as well. The solution to the problem is sought through technical measures (manure processing). The decision about a decrease in the Dutch livestock population will be postponed until 1995.

The Dutch manure problem is an example of and a warning about the problems of modern agricultural developments, and also about the excessive and detailed regulations required to deal with these problems. Hopefully, this will remain a strange story for the American people that once came from the Netherlands, and never will become a reality in the USA.

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98. *Id.* at 11-12.

99. *Id.* at 2.

100. See H. van Katteler & H. van den Tillaart, *Veehouders en Mestbeleid*, Instituut voor Toegepaste Sociale Wetenschappen, Nijmegen 1989. According to this research report 79% of the manure-producing farmers agreed with the phosphate standards for the first phase; 66% considered the rules about spreading manure to be fair; 76% thought the obligation to work manure into the soil was justified; and 34% considered the regulations about the transfer of manure production to be fair. On certain questions there was much diversity between the different groups of farmers. For instance, 64% of the cattle farmers thought it was fair that they have to pay a levy on excess manure, 45% of the pig farmers agreed so, and only 24% of the poultry farmers agreed.

## **Legal Concerns Triggered by Alternative Land Use — Subtle Issues and Potential Traps**

**CYNTHIA BOYER BLAKESLEE\***

According to the common law and tradition, landowners should be able to use their land as they choose. Farmers and rural landowners identify strongly with their land ownership and property rights. They naturally assume that they can do as they please with land they own. In many cases, the land has been part of the family heritage for many generations. Counsel must be alert to the domino effect that a change in land use, from agriculture to some other enterprise, can initiate. In addition, the attorney must be insistent and unequivocal in bringing home to the client the many consequences and the complex legal problems the landowner could face.

This Article is not exhaustive. It is intended only to highlight some of the more interesting and unexpected possible consequences of a change in land use.

### **I. DEED RESTRICTIONS**

The initial inquiry to be made before seriously contemplating alternative use of the land is to ascertain what restrictions run with the land by virtue of clauses in deeds or separately recorded restrictive or permissive easements, restrictive covenants, or rights of way. It is not sufficient to examine only the deed that conveyed the property to the present landowner. A thorough title search requires a meticulous, or perhaps a slightly paranoid, title searcher. Many old deeds contained what best can be described as peculiar restrictions and Draconian reversionary clauses for breaching these restrictions. Rights of way granted in different days under different circumstances must either be extinguished or provided for in the plans for alternate land use. Those restrictions that violate public policy or conflict with present civil rights and equal access legislation might be voidable by an action to quiet title or similar court action. At a minimum, such actions cost time and money. The outcome of a quiet title suit is by no means certain because of the strong common law bias in favor of allowing landowners to do as they please with their property and the strong private property rights associated with land ownership.

Agricultural and open space easements are in vogue in many areas of the country. Once these restrictions are placed on a tract, they

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remain in force and limit the use of the land in perpetuity or for the term of years specified. "Clean and green" and other preferential tax assessments allowed for agricultural land might be evidenced by recorded easements or by registries in the county courthouse. Old restrictive covenants might control such unlikely considerations as storm water runoff.<sup>1</sup> If the matter has been dealt with previously and resolved by a recorded document, courts will not apply statutes or case law to the facts.<sup>2</sup>

## II. TAX PREFERENCES

Jurisdictions that grant preferential tax assessment to farmland or land used for agricultural purposes base the value of the land on its agricultural use rather than its highest and best use. State constitutional requirements of equality and uniformity of taxation and equal protection clauses generally have not been a bar to preferential assessment. A few courts have overturned preferential treatment.

The statutory requirements for granting preferential assessment are diverse. They look both to the use of the land and to the occupation of the taxpayer. Among the use criteria employed are:

- actual cultivation of the land
- limitation to minimum lot size
- exclusion of the value of the farmhouse from the preferential assessment
- restriction to solely agricultural use
- restriction to primarily agricultural use
- disqualification of the land from preferential tax treatment for diverting the use to different or additional activities

Especially in states that rapidly are losing farmland to development, restrictions are being placed on preferential assessment to balance competing tensions. Allowing farmers to continue agricultural activities in areas with high real estate values and intense development pressures is weighed against granting unjustified and unexpected tax assessment windfalls to speculators bidding their time for development opportunity.

Legislation has addressed these opposing interests by incorporating penalties for terminating prematurely the agricultural use. Alternatively, preferential tax treatment might be conditioned upon the landowner's entering into a long-term contract, restricting the use of the land, with the taxing body. The land alternatively might be subject to a rollback tax upon the cessation of the agricultural use.

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1. See, e.g., *Woodward v. Cloer*, 68 N.C. App. 331, 315 S.E.2d 335 (1984).

2. *Id.*

In the good-faith attempt to address all of these concerns, to achieve a result that meets constitutional mandates of equal protection and uniformity, and — more basically — to give the appearance of fairness, courts have engaged in tortuous reasoning. In *North Eastern Fruit Council v. State Board of Equalization and Assessment*,<sup>3</sup> the court rejected preferential assessment for land devoted to an apple orchard. The court held that vineyards and orchards fundamentally were different because they contained components of taxable real property not present in other types of agricultural land.<sup>4</sup> The fruit trees themselves were the component of taxable real property.

Conversely, Florida courts treat orange groves as an agricultural use. In *Hausman v. Hartog*,<sup>5</sup> the court found that twenty-five acres used for an orange grove were entitled to preferential treatment. However, twenty-five acres of vacant land were improperly classified as agricultural use. This decision addressed the concerns that developers might profit and that areas of Florida currently devoted to production agriculture have intense development pressures.

New Jersey also is under strong developmental pressures. The court in *Jackson Township v. Paolin*<sup>6</sup> analyzed a statute requiring assessment of rollback taxes when agricultural property was applied to a use other than agriculture or horticulture. The court held that ceasing the agricultural use was not sufficient to trigger a rollback provision absent employment of the property in another activity.<sup>7</sup>

Consistent with *Jackson Township* is *Department of Environmental Protection v. Franklin Township*.<sup>8</sup> In *Franklin Township*, the state acquired land classified as agricultural to develop a reservoir. The fact that the reservoir was used to benefit agriculture in the region did not preserve preferential assessment.<sup>9</sup> In addition, the property became subject to the rollback provision upon the date of cessation of the agricultural use.<sup>10</sup>

The distinguishing feature between the Florida case and the two New Jersey cases seems to be timing. Once the subsequent use begins, the New Jersey rollback relates back to cessation of the use. The effect on the developers is the same. Although New Jersey developers will

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3. 124 Misc. 2d 67, 475 N.Y.S.2d 1010 (N.Y. Sup. Ct. 1984), *aff'd*, 115 A.D.2d 139, 495 N.Y.S.2d 925 (N.Y. App. Div. 1985).

4. *Id.* at 69, 475 N.Y.S.2d at 1012.

5. 371 So. 2d 1036 (Fla. Dist. Ct. App. 1978).

6. 181 N.J. Super. 293, 3 N.J. Tax 39, 437 A.2d 344 (1981).

7. *Id.* at 309, 437 A.2d at 353.

8. 181 N.J. Super 309, 3 N.J. Tax 105, 437 A.2d 353 (1981).

9. *Id.* at 330, 437 A.2d at 364.

10. *Id.* at 337, 437 A.2d at 368.

enjoy the cash flow benefit of the preference for a longer time than developers in Florida, the former will pay the full price when they go on to other activities.

In *Smith v. Padgett*,<sup>11</sup> the applicable agricultural use provision of the property assessment statute required that livestock be raised under natural conditions as a venture for profit. A feedlot operation did not qualify as a natural condition.<sup>12</sup>

### III. FINANCING

Because of the high number of troubled financial institutions, lender nervousness about the falling real estate market, and general concerns about the economy, lenders are scrutinizing loan applications and the supporting documentation carefully and are monitoring outstanding loans diligently. Major issues for borrowers considering alternative uses of their land follow.

#### A. *Loan Purpose*

When funds are borrowed from governmental entities, drastic results might follow when the borrower diverts the proceeds of the loan. Persons presenting false applications for the loans under the Commodity Credit Corporation and other federal preference programs are subject to the criminal punishments and civil penalties of the False Claims Amendment Act of 1986.<sup>13</sup>

Commercial loans and lines of credit from conventional lenders generally are made on the basis of loan purpose. Applying the proceeds to an activity or purpose other than that stated on the loan application breaches the contract with the lender and could cause acceleration of the loan or calling of a note.

#### B. *Source of Funds*

A second constraint upon the use of the loan proceeds is the source of the funds. Funds lent under specific entitlement programs often are subject to income limitations and restrictions on the timing of advances and repayments of proceeds. Generally, the loan agreement tightly structures the application of loan proceeds.

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11. 596 S.W.2d 530 (Tex. Civ. App. 1979), writ ref. n.r.e.

12. *Id.* at 533.

13. 31 U.S.C. § 3729 (1988 & Supp. 1990). Penalties are found at 18 U.S.C. § 1001 (1976).

### *C. Lender Assessment of Risk*

The purpose of the loan might significantly alter the lender/borrower relationship. Agricultural landowners who are accustomed to borrowing on revolving lines of credit or seasonal notes might find that the lender assessment of the financial risk of the alternative activity or land use is different. In particular, some lenders view recreational enterprises as unstable and subject to declining revenues during periods of economic downturn. The results of a less favorable assessment of the risk include:

- increasing the amount of collateral required
- reducing the term of the loan
- increasing the rate of interest to compensate for the additional risk
- requiring personal guarantees and third-party guarantees

### *D. Environmental Audit Requirements*

Because of the requirements of the Federal Superfund Law<sup>14</sup> and the applicable state hazardous site cleanup acts, lenders increasingly require environmental audits prior to committing to loans. This requirement has been imposed upon current landowners seeking new financing, additional financing, or refinancing. The most basic Phase I audit can carry a price tag of \$5,000. If any problem is revealed at the Phase I stage, more detailed audits are required to perform exhaustive site testing. As the sophistication in site testing increases, so does the cost. Landowners wind up between the proverbial rock and hard place. They already own the site. They cannot walk away from the deal. Whether or not the loan is granted, the landowner must face the remediation (cleanup) costs.

## IV. ZONING

Each zoning ordinance is unique. Not all agricultural use ordinances are drafted equally. The crucial element to any analysis of the legality of an activity in a particular land use district is the applicable zoning ordinance. No generalizations can be made about which activities will be classified as an agricultural use or which activities will be permitted in a district zoned rural or agricultural. In addition, zoning decisions are political. They are made by elected officials responsive to the biases

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14. Comprehensive Environmental Response Compensation and Liability Act (CERCLA), 42 U.S.C. § 9601 (1988 & Supp. 1990); *see infra* note 80 and accompanying text.

and prejudices of their constituents. The results frequently turn upon who the applicant is and the local sentiment concerning the activity. Neighborhood opposition is a factor in the decision-making process.

Abuses of discretion in zoning decisions are appealable. Appeals take time and cost money. To the extent appeals are decided upon the record made before the local government agency, a meaningful change in result on appeal is doubtful. The following sections discuss crucial zoning issues.

#### *A. Definitions*

The scope of activities permitted or precluded is strictly a factor of the definition of terms. Key terms are defined so disparately as to produce diametrically opposite results. Zoning ordinance terms are construed according to the standard dictionary definition unless a more specific definition of the term is provided in the definitions section or unless a special purpose definition is provided in a particular section. All zoning is in derogation of the state or commonwealth. Therefore, any ambiguity is construed in favor of allowing the landowner to use the land as the landowner chooses. The terms that cause special concern in considering alternative use of the land are "agricultural use" and "farm use."

In *Barnhart v. Zoning Hearing Board*,<sup>15</sup> use of land for boarding horses was sufficiently pastoral in nature to classify it as "agriculture" pursuant to the statutory definition, despite the "clearly commercial" aspects of the operation. The court noted that eighteen of the thirty-three horses boarded were pastured on a full-time basis and that the remaining horses were pastured on a part-time basis.<sup>16</sup>

In *Zoning Hearing Board v. Zlomsowitch*,<sup>17</sup> the ordinance provided that buildings devoted to farm use were exempt from area regulations. The court found that the ordinary meaning of "farm use" was synonymous with agricultural use and that use encompassed the keeping of horses.<sup>18</sup> Conversely, in *Appeal of Jaffe*,<sup>19</sup> although the R-2 zoning designation permitted agricultural land use, the court held that the construction of buildings designed for commercial boarding of horses was not an agricultural use within the terms of the ordinance.<sup>20</sup>

In *Farmegg Products, Inc. v. Humboldt County*,<sup>21</sup> proposed mechanized chicken houses did not qualify for exemption as an agricultural

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15. 49 Pa. Commw. 481, 411 A.2d 1266 (1980).

16. *Id.* at 484, 411 A.2d at 1268.

17. 87 Pa. Commw. 123, 486 A.2d 568 (1985).

18. *Id.* at 126, 486 A.2d at 569.

19. 100 Pa. Commw. 498, 514 A.2d 1016 (1986).

20. *Id.* at 503, 514 A.2d at 1019.

21. 190 N.W.2d 454 (Iowa 1971).

use. The birds were to be raised from small chicks to laying hens.

The distinction between *Barnhart* as a permitted use and *Appeal of Jaffe* and *Farmegg* as not-permitted uses seems to lie in natural versus artificial conditions. The *Barnhart* court paid attention to the fact that the horses were pastured.<sup>22</sup> In *Farmegg Products*, the court considered a sophisticated commercial operation.<sup>23</sup> A like result to *Farmegg* could be expected for veal calf confinement houses, sow-farrow operations, or any similar husbandry activity that takes place in artificial-light, a climate-controlled environment, or both.

In *Commonwealth v. Proctor*,<sup>24</sup> raising minks was not a permitted use under the designation "farm" because minks were not included in the phrase "domestic or other animal." The land therefore was not devoted to an agricultural purpose within the terms of the ordinance.<sup>25</sup>

In *Davidson v. Abele*,<sup>26</sup> the operation of a mink ranch fell within the definition of "agriculture." The statute defined "agriculture" as including animal husbandry, which in turn included the operation in question. Because the activity was "agriculture," the Board of Commissioners had no authority to zone.<sup>27</sup>

In *Harris v. Rootstown Township Zoning Board of Appeals*,<sup>28</sup> the court held that the breeding, raising, and care of dogs constituted "animal husbandry." That term was included in the term "agriculture" as defined in the zoning statute and included the use of land or buildings for "agriculture." The statute exempted such use from zoning regulation.

In *Appeal of Lowney*,<sup>29</sup> the court held that the use of a kennel for the purpose of boarding and grooming dogs could not be classified as a traditional agricultural use permitted in an industrially zoned area. However, the determination that the use was of the same general character as permitted uses justified the granting of a special exception to construct the kennel.<sup>30</sup>

In *County of Kendall v. Aurora National Bank Trust No. 1107*,<sup>31</sup> the statutory definition of agricultural use did not include sand mining. The owners claimed that they excavated the sand to create a pond to

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22. *Barnhart*, 49 Pa. Commw. at \_\_\_\_, 411 A.2d at 1268.

23. *Farmegg Products*, 190 N.W.2d at 458-60.

24. 355 Mass. 504, 505, 246 N.E.2d 454, 455 (1969).

25. *Id.*

26. 2 Ohio App. 2d 106, 206 N.E.2d 583 (1965).

27. *Id.* at 107, 206 N.E.2d at 584.

28. 44 Ohio St. 2d 144, 149-50, 338 N.E.2d 763, 767 (1975).

29. 46 Pa. Commw. 213, 217, 406 A.2d 1160, 1162 (1979).

30. *Id.* at 218, 406 A.2d at 1162.

31. 170 Ill. App. 3d 212, 524 N.E.2d 262 (1988), *appeal denied*, 122 Ill. 2d 576, 530 N.E.2d 242 (2d Dist. 1988).

irrigate the sod that they had planted. Sod growing was an agricultural use within the statute. The landowners also had an existing gravel and sand operation and had applied for rezoning to a mining classification. In determining if the use was an agricultural purpose, the court "focused on the nature of the specific activity being conducted in relation to the definition of agriculture."<sup>32</sup> The evidence supported the contention of the property owner that the pond they intended to dig would be used for agricultural purposes.

### B. Extent of Use

In some cases, activities are classified under a particular ordinance so long as they fall within certain parameters. At some point in the expansion process, these activities lose their agricultural status.

In *Farmland Industries, Inc. v. Zoning Hearing Board*,<sup>33</sup> the ordinance permitted the sale of farm products by special exception in certain agricultural and residential districts. No language in the ordinance restricted the farm products permitted to be sold to those produced on the farms of the holder of the special exception. The broad definition included fruits, vegetables, eggs, milk, butter, poultry, and meat that had not been substantially processed or commercially packaged, bottled, or canned.

In *Anderson v. Humble Oil & Refining Co.*,<sup>34</sup> the court held that the growing of nursery plants was farming. The use would extend to selling plants grown upon the land. However, the owners of the tract not only were growing plants on the property but also were buying and reselling large quantities of nursery plants. The additional activity supported a holding that the property was used for commercial purposes.<sup>35</sup>

In *Jackson v. Building Inspector*,<sup>36</sup> the court considered the use of a dehydration machine on a farm to be an accessory use incident to farming. The use fit within the zoning ordinance if it was restricted to fodder and manure actually used or produced on the farm.

In many areas of the country, a sawmill is a fixture on the farmstead. However, in *Smith v. Miller*,<sup>37</sup> when the sawmill was used to manufacture excelsior, wood fiber, or sawdust products, the court held the use was not agricultural.

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32. *Id.* at 216, 524 N.E.2d at 265.

33. 65 Pa. Commw. 288, 442 A.2d 395 (1982).

34. 226 Ga. 252, 253, 174 S.E.2d 415, 417 (1970).

35. *Id.* at 254, 174 S.E.2d at 417.

36. 351 Mass. 472, 477, 221 N.E.2d 736, 739 (1966).

37. 249 Md. 390, 239 A.2d 900 (1968).

### C. *Incidental Uses*

In *Schantz v. Rachlin*,<sup>38</sup> an airplane landing strip limited to personal use was an accessory use of the property in a residential and agricultural district. The zoning ordinance defined an accessory use as clearly incidental to or subordinate to the principal use and located on the same lot as the principal use. The airplane was owned by a farmer who cultivated crops and raised livestock on approximately 135 acres. The airstrip was unlighted and used only in daytime. Photographs showed that the airstrip did not alter the appearance of the farm. There were no buildings incident to the airstrip. The plane was used only for the farmer's personal pleasure. The court analogized the farmer's use of and pleasure from an airplane to having a pool or radio antenna support, which already were permitted uses.<sup>39</sup> The court noted that although airstrips were not as prevalent in the defendant's location as in other parts of the country, the use of private aircraft is expanding.<sup>40</sup> The court further rejected a neighbor's contention that the owner's use of the airplane in part for a real estate and investment business made these enterprises the primary use for the craft.<sup>41</sup>

## V. EQUAL ACCESS AND CIVIL RIGHTS CONSIDERATIONS

Federal civil rights laws and various state public accommodation acts restrict landowners' ability to allow only those people with whom they are comfortable to come onto their land. The goal of the various civil rights mandates is to protect certain classes of individuals from discrimination and to ensure that they are accorded equal protection of laws both under the United States Constitution and under various state constitutions. The following examples of such laws by no means are exhaustive. They serve only to suggest the scope of the problem.

Federal law makes it illegal for two or more persons to conspire to deprive any person the equal protection of the law.<sup>42</sup> In particular, various occupational groups have sought status as protected classes. A plaintiff must show that the defendant's actions were motivated by racial or otherwise class-based invidiously discriminatory animus. Generally, the protected classes are race, ethnic origin, sex, religion, and political loyalties. An advocate for the rights of nursing home patients was not allowed the protection of the Act.<sup>43</sup>

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38. 101 N.J. Super. 334, 244 A.2d 328 (1968), *aff'd*, 104 N.J. Super. 154, 249 A.2d 18 (1968).

39. *Id.* at 341, 244 A.2d at 332.

40. *Id.* at 342, 244 A.2d at 333.

41. *Id.*

42. 42 U.S.C. § 1985 (1988).

43. *Hack v. Oxford Health Care, Inc.*, 562 F. Supp. 295 (N.D. Ind. 1983).

In *Griffin v. Breckenridge*, the United States Supreme Court held that to state a claim under section 1985(3) or the pertinent part of subsection (2), a plaintiff must allege racial or otherwise class-based motivation for the conspirator's action.<sup>44</sup> Although the allegation was racial bias, "otherwise class-based invidiously discriminatory animus" has been relied on in employment cases as the litmus test for section 1985 civil rights conspiracy claims.

Generally, discrimination against an occupational class is not the kind of irrational class discrimination that is protected. Farm workers are an exception. They have been held to constitute a class of persons within the meaning of section 1985(3). Advocates for farm workers have argued that the occupational group constitutes a class of persons and that the class has been subject to the types of actions that Congress intended to prohibit.

In considering the actions of a tobacco growers association, the United States District Court for Connecticut held that camp rules dealing with access to labor camps infringed upon the freedoms of speech, religion, and association.<sup>45</sup>

Title II of the Civil Rights Act of 1964<sup>46</sup> proscribes discrimination and segregation based on race, color, religion, or national origin in motion picture houses, theaters, concert halls, sports arenas, or other places of exhibition or entertainment. Over the years, court decisions have expanded the Civil Rights Act to include both spectator events and active participation in sports or other activities.

A family-owned recreation complex with a swimming area, picnic area, dancing area, snack bar, pool tables, and jukebox was held to be "a place of entertainment."<sup>47</sup> In this case, it is significant that all of the directors were related to the corporate president by blood or marriage, and that the president and his wife owned all of the stock in the corporation. This was the quintessential family business.

A facility owned and operated by a youth football association to conduct its football program was "a place of entertainment" within the meaning of the same Act.<sup>48</sup> A similar result would likely follow for a day camp, a sports camp, or some other recreation or athletic facility open to the public.

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44. *Griffin v. Breckenridge*, 403 U.S. 88, 102 (1971).

45. *Velez v. Amenta*, 370 F. Supp. 1250, 1256 (D. Conn. 1974).

46. 42 U.S.C. § 2000a (1988).

47. *United States v. Johnson Lake, Inc.*, 312 F. Supp. 1376, 1380 (S.D. Ala. 1970).

48. *United States v. Slidell Youth Football Ass'n*, 387 F. Supp. 474, 482 (E.D. La. 1974).

The denial of admission to a skating rink based upon hair length did not state a cause of denial of equal accommodation under a Michigan statute.<sup>49</sup> However, an amendment to the statute proscribed sex discrimination. Because the length of hair test applied only to males, the defendant in the future could refuse to admit the plaintiff only for actual misconduct.<sup>50</sup>

State and federal equal access legislation could require modification of any facility to meet the needs of the public. Recent federal legislation and the laws of the particular state must be carefully reviewed. The Americans With Disabilities Act of 1990<sup>51</sup> prohibits discrimination in the areas of employment, public services, public accommodations, services operated by private entities, and telecommunications against persons with disabilities. The Act specifically at section 2(a)(3) addresses the need to make recreational opportunities accessible. The mandate of the Act to make parking lots, access routes to and from buildings, entrances, bathrooms, and common areas readily accessible to and usable by those who are hearing impaired, visual impaired, or who are wheelchair-bound must be of special consideration to persons who invite the public onto their land. Regulations have not been promulgated to date. In their absence, construction and facilities design should be undertaken only in careful consultation with architects and designers experienced in projects which meet these needs.

## VI. EMPLOYER/EMPLOYEE ISSUES

### *A. Disability Insurance for the Landowner*

A major reason for taking land out of agriculture or farm use is that the landowners no longer are able to work the land, tend the livestock, or milk the cows. Disability insurance for many self-employed persons provides a financial safety net in the event of illness or injury. The insurance yields steady income that allows the recipients to meet their obligations and, to some extent, maintain their lifestyles.

Any consideration of utilizing the land to obtain some alternative source of income must address the consequences of disability insurance or social security payments. Budding enterprises notoriously generate a lot of red ink. A crushing blow to the landowner can result when the safety net he or she counted on also vanishes just when the landowner is most desperate for regular income. The landowner's right to receive

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49. *Riegler v. Holiday Skating Rink, Inc.*, 48 Mich. App. 449, 451, 210 N.W.2d 454, 456 (1973), *aff'd*, 393 Mich. 607, 227 N.W.2d 759 (1975).

50. *Id.* at 452, 210 N.W.2d at 456.

51. Act of July 26, 1990, Pub. L. No. 101-336.

income depends upon the policy language. Crucial words and phrases include:

- total disability
- permanent disability
- continuous disability

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The meanings given to these terms are questions of law. Any determination of total disability looks to whether the policy is an occupational disability policy or a nonoccupational policy.

An occupational disability policy protects against the loss resulting from the inability to engage in a particular occupation. Usually the occupation is that in which the insured is engaged at a particular time. An occupational disability policy gives the insured the right to claim benefits if the insured is disabled from that occupation even though the insured might be able to engage in some other type of work.

A nonoccupational policy, more commonly known as general disability insurance, provides protection only when the individual is unable to engage in any remunerative occupation or work. The ability to engage in any occupation for wages or profit generally is interpreted to relate to an occupation in which the insured is trained or has worked at some time during his or her lifetime or to an occupation that the insured could follow based upon his or her particular age, training, experience, reputation, and other relatively precise factors. As in all other areas to be considered, the interpretations of these general concepts vary by policy language and court decisions. Whether the insured is able to collect under the policy depends upon the interpretation of the term "total disability."

The liberal viewpoint is that benefits are paid when the claimant is unable to work in his or her particular occupation. This viewpoint is illustrated by the case in which a dairy farmer sold his herd because of heart trouble.<sup>52</sup> Coverage under the disability policy was allowed in that case even though the farmer engaged in a trucking business and enjoyed improved health while so doing.<sup>53</sup> The policy covered occupational disability.

A middle-of-the-road approach is that if the claimant is unable to work in his or her particular occupation or another occupation for which he or she is fitted or qualified, the claimant will recover under a nonoccupational policy. An illustration of this intermediate view involves a fruit grower who was considered totally disabled when he was afflicted by tuberculosis to such a degree that he could not earn wages for profit

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52. *Scharbach v. Continental Casualty Co.*, 83 Idaho 589, 366 P.2d 826 (1961).

53. *Id.* at 597, 366 P.2d at 830.

within the range of his capabilities.<sup>54</sup> His disability was recognized even though he was able to fish and hunt occasionally. Significant, however, is the fact that this claimant had very little schooling and had only engaged in sheep raising in addition to fruit growing.

The strictest viewpoint is that the claimant is unable to work in any occupation whatsoever. This harsh view was implemented in denying recovery to a farmer who was prevented from continuing farm work.<sup>55</sup> The farmer's only employment was \$40.00 a month as a court crier. The policy prevented a claimant "from pursuing any occupation whatsoever for remuneration or for profit."

The eligibility requirements and disqualifications for benefits under the Social Security Act contain numerous traps for unwary land use and business attorneys who do not regularly practice this specialized branch of administrative law. There are two distinct programs: The Old Age, Survivors and Disability Insurance Program (OASDI)<sup>56</sup> and the Supplemental Security Income (SSI).<sup>57</sup> The former is an insurance benefit that requires the claimant to be fully insured by meeting earnings-related requirements. The latter is a needs-based program. Both programs are grounded in statutory and regulatory provisions replete with terms of art. These terms must be met squarely. Qualification under one program does not guarantee qualification under the other. Disqualification from one program does not necessarily cause disqualification from the other. The economic feasibility of any alternative land use plan for a benefits recipient can be evaluated only after consultation with competent claimants' counsel who has a thorough working knowledge of the system.

### *B. Agricultural Employees*

The Migrant and Seasonal Agricultural Worker Protection Act<sup>58</sup> protects employees engaged in agriculture. What constitutes "agricultural employment" is defined to be

employment in any service or activity included within the provisions of section 3(f) of the Fair Labor Standards Act of 1938 (29 U.S.C. 203(f) [29 USCS § 203(f)]), or § 3121(g) of the Internal Revenue Code of 1954 (26 U.S.C. 3121(g) [26 USCS

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54. Shockley v. Travelers' Ins. Co., 17 Wash. 2d 736, 137 P.2d 117 (1943).

55. Thigpen v. Jefferson Standard Life Ins. Co., 204 N.C. 551, 168 S.E. 845 (1933).

56. 42 U.S.C. § 402 (1988 & Supp. 1990), with regulations promulgated at 20 C.F.R. §§ 404.1-2127 (1990).

57. 42 U.S.C. §§ 1381-1599 (1988 & Supp. 1990), with regulations promulgated at 20 C.F.R. § 416.101-2227 (1990).

58. 29 U.S.C. §§ 1801-1872 (1985 & Supp. 1990).

§3121(g)]) and the handling, planting, drying, packing, packaging, processing, freezing, or grading prior to delivery for storage of any agricultural or horticultural commodity in its unmanufactured state.<sup>59</sup>

Various court decisions have brought within the scope of this definition employees engaged in the following activities:

- forestry and horticulture
- fur-bearing animal husbandry
- weeding or compost removing
- cannery or packing work

Decisions have exempted from the definition:

- drivers of vans or buses used to transport such workers
- employees of tobacco haulers

The Fair Labor Standards Act of 1938,<sup>60</sup> as amended, exempts agricultural workers. The distinctions are subtle. The Seventh Circuit affirmed a National Labor Relations Board determination that employees of five out of six duck farms were exempt agricultural employees.<sup>61</sup> Employees of the sixth farm were not exempt because a substantial and regular amount of their work was with ducks of contract growers.<sup>62</sup> However, the employees of the sixth farm were exempt from the particular bargaining unit because they did not share a sufficient community of interest to warrant their inclusion in the bargaining unit.<sup>63</sup>

In another case, piece-work woodsmen who felled trees and hauled them on tractors leased by the employer and recruited crews were not considered "agricultural workers" within the exclusion from the definition of employee contained in the National Labor Relations Act.<sup>64</sup> Their work was integrated into an industrial production process.

By contrast, the National Labor Relations Act is not applicable to nursery employees who spent 68%-77% of their time in the fields.<sup>65</sup>

## VII. ENVIRONMENTAL ISSUES

Local ordinances provide many of the parameters and limitations involved in environmental issues. Zoning ordinances, storm water or-

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59. 29 U.S.C. § 1802(3) (1988).

60. 29 U.S.C. § 201 (1988 & Supp. 1990).

61. NLRB v. C & D Foods, Inc., 626 F.2d 578 (7th Cir. 1980).

62. *Id.* at 582.

63. *Id.* at 583.

64. NLRB v. Scott Paper Co., 440 F.2d 625, 626 n.3 (1st Cir. 1971); see 29 U.S.C. § 152(3) (1973).

65. NLRB v. Kelly Bros. Nurseries, Inc., 341 F.2d 433 (2d Cir. 1965).

dinances, on-lot standards for sewage treatment, and requirements that condition certain uses of the land upon availability of public water and sewers all affect the landowner's ability to use the land. Local ordinances requiring environmental impact statements as a condition for zoning approval or variances look to such factors as air pollution, noise level, drainage and flooding, aesthetics, the ability of the project to fit into the existing community, and soil type.

#### *A. Environmental Impact Report Requirements*

A plan submitted by timber companies pursuant to a state forest practice act that was not accompanied by an impact report was promptly set aside.<sup>66</sup> The court found that the timber harvesting had a significant effect on the environment, and held that the proposed activity came within the California Quality Act concept of "project."<sup>67</sup>

Mini-warehouses, because of their collapsible nature, often provide an interim source of income from the land. One court held that the rezoning of a property from rural undeveloped to light manufacturing to permit construction of mini-warehouses had no environmental significance.<sup>68</sup> The proposed development was not a major action when environmental and socioeconomic factors had to be considered. The assessed factors included anticipated increased traffic; available water, sewage, and electrical service; proposed tenants' business operations; the need for the proposed use in the area; the current real estate market; and the availability of other light manufacturing sites.

#### *B. Surface Waters — Applicable Rules*

1. *Civil Law.*—The owner of the dominant (higher) tract has an easement in the servient (lower) tract to allow surface waters to flow naturally.<sup>69</sup> The owner of the servient tract is not required to accept water flowing from the dominant tract that would not do so in the course of nature.<sup>70</sup>

In Illinois, the civil law rule has been modified by the "husbandry" exception. The interference with surface waters will be allowed if it is limited to that which is incidental to the reasonable development of the

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66. *Natural Resources Defense Council, Inc. v. Arcata Nat'l Corp.*, 59 Cal. App. 3d 959, 131 Cal. Rptr. 172 (1976).

67. *Id.* at 967, 131 Cal. Rptr. at 177.

68. *Murden Cove Preservation Ass'n v. Kitsap County*, 41 Wash. App. 515, 525, 704 P.2d 1242, 1249 (1985).

69. *Seminole County v. Mertz*, 415 So. 2d 1286, 1289 (Fla. Dist. Ct. App. 1982), *rev. denied*, 424 So. 2d 763 (Fla. 1982).

70. *Id.*

dominant lands for agricultural purposes. The decision to abandon an activity that has been construed as agricultural can expose a landowner to a myriad of restrictions from which he or she previously had been excepted or exempt.

Even when the total amount of water flowing from the dominant estate onto the servient estate does not change, injunctive relief or money damages might be granted when the water is so concentrated in discharge and the concentration is caused by the construction of roads and culverts.<sup>71</sup>

2. *The Common Enemy Doctrine*.—The basic premise of this doctrine is that surface water is the common enemy and landowners may fight it off as best they can, provided the landowners do so reasonably and in good faith and not wantonly, unnecessarily, or carelessly.<sup>72</sup> The Indiana version of the same rule states that the landowner cannot throw or cast water upon adjacent property in unusual quantities.<sup>73</sup>

3. *The Reasonable Use Modification of the Common Enemy Doctrine*.—All landowners have the right to use their property, but must do so in a manner that does not cause unnecessary injury to other landowners in light of the surrounding circumstances. Factors that contribute to an analysis of the reasonableness of the use include: whether the improvements are the cause in fact of the injury to the servient landowner, the nature and importance of the improvements, the relative value of the harm compared with the relative value of the improvements, the foreseeability of injury, the extent of interference with surface water, the availability of mutually acceptable solutions to the drainage problems, and any negligent or willful misconduct by the owner of the dominant estate.<sup>74</sup>

In an Alabama case, judgment was entered and affirmed against the upper landowner for causing damage to the lower landowner when the evidence showed that the lower landowner only had problems with water drainage after the upper landowner began construction on his property.<sup>75</sup> In this case, the construction increased storm water runoff by fifty percent. Removal of underbrush and trees coupled with construction of a driveway caused surface water to be channeled directly onto the lower property. The upper landowner also changed the grade of his property. This case especially is worth noting when planning to adapt agricultural land to activities in which large numbers of people

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71. Powers v. Judd, 150 Vt. 290, 553 A.2d 139 (1988).

72. See Mullins v. Greer, 226 Va. 587, 311 S.E.2d 110 (1984).

73. See Argyelan v. Haviland, 435 N.E.2d 973 (Ind. 1982).

74. Argyelan v. Haviland, 435 N.E.2d 973, 977 (Ind. 1982); Rounds v. Hoelscher, 428 N.E.2d 1308, 1315 (Ind. Ct. App. 1981) (disapproved on other grounds).

75. Johnson v. Washington, 474 So. 2d 651 (Ala. 1985).

will be brought onto the land. To accommodate the public, construction of driveways, construction of parking lots, and brush-clearing are common modifications.

Covenants running with the land either as separately recorded documents or as restrictive clauses in deeds or easements must be scrutinized carefully with respect to surface water restrictions. For example, in *Woodward v. Cloer*, the court would not apply the reasonable use standard to an action to enforce a restrictive covenant prohibiting any obstruction or interference with the flow of water through the drainage channels within the easement.<sup>76</sup> The court reasoned that the rule was applicable only to determine the rights and duties of landowners in the absence of another source for reciprocal rights and obligations.<sup>77</sup> Because the rights and obligations sought to be enforced were expressly contained in the restrictive covenants, the court held that there was no need for the trial court to make a determination of the plaintiff's right to recover.<sup>78</sup>

Limiting any analysis to the case law in a given jurisdiction dealing with surface water is insufficient. Counsel also must research applicable federal and state wetlands regulations, state environmental laws, and municipal storm water ordinances.

### C. Wetlands

Compliance with wetlands regulations is difficult because of the overlapping jurisdiction and sometimes conflicting regulations involved. Among the actors are the United States Soil and Conservation Service, the United States Fish and Wildlife Service, the United States Army Corps of Engineers, the Federal Environmental Protection Agency, and state departments of environmental resources (known by a variety of similar names). Until recently, even the identification systems were at odds. Currently, the *Federal Manual for Identifying and Delineating Jurisdictional Wetlands*,<sup>79</sup> an interagency cooperative publication of the Fish and Wildlife Service, the Environmental Protection Agency, the Department of the Army, and the United States Soil Conservation Service, is utilized by all of those agencies and is recognized as definitive by some *but not all* state environmental resource agencies.

The United States Army Corps of Engineers employs a nationwide permitting system whereby projects that strictly meet the permit criteria are approved. However, no matter how surely a project falls within one

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76. 68 N.C. App. 331, 315 S.E.2d 335 (1984).

77. *Id.* at 334, 315 S.E.2d at 337.

78. *Id.* at 335, 315 S.E.2d 337.

79. FEDERAL INTERAGENCY COMM. FOR WETLAND DELINEATION, FEDERAL MANUAL FOR IDENTIFYING AND DELINEATING JURISDICTIONAL WETLANDS (Jan. 1989).

of the Corps nationwide permits, there is no assurance that the activity will be allowed under state regulations. Most states recognize some but not all of the nationwide permits.

Wetlands regulations carry beneficial exemptions and grandfather provisions for certain continuous agricultural uses. The minute the land use ceases to fit strictly within the saving provision, this protection also is lost and strict compliance with all the agencies and all the regulations coming to bear on wetlands is required.

Wetlands issues cannot be dealt with as the project progresses. Violators are punished with harsh fines, remediation requirements, or both. Remediation easily can be 2:1. In addition, DER and the Corps of Engineers in various parts of the country have begun seeking criminal penalties against what the agencies perceive to be flagrant or egregious violations. No dirt should be moved and no ditch should be filled until the issue is resolved if the remotest possibility of a wetlands issue is present.

#### *D. Superfund*

The Federal Superfund Law, officially known as the Comprehensive Environmental Response Compensation and Liability Act (CERCLA)<sup>80</sup> as amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), imposes broad-based liability and severe penalties. Many states have enacted their own versions of the Superfund. These enactments have been the subject of numerous continuing legal education programs. The legislation is complex and highly technical. A detailed discussion is beyond the scope of this Article. For purposes of counseling landowners who wish to make alternative uses of their land, it is imperative that the attorney be thoroughly familiar with the requirements of the federal and pertinent state clean up laws. It is crucial to know the points upon which the two laws differ and to resolve any conflicts in interpretation or compliance with the regulating agencies. Possible exemptions exist for family farms in some of the state statutes. When the family farm ceases to be a family farm, possible exemptions are inapplicable and the duty to clean up is imposed.

#### *E. Endangered Species Protection*

The Federal Endangered Species Act<sup>81</sup> and various state game codes and fish codes generate a list of endangered and threatened animal and bird species.<sup>82</sup> Generally, there is a prohibition against killing endangered

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80. 42 U.S.C. §§ 9601-9675 (1988 & Supp. 1990).

81. 16 U.S.C. §§ 1531-1544 (1988 & Supp. 1990).

82. 50 C.F.R. §§ 401-453 (1990); *id.* § 17.

species, even indirectly, by disturbing or destroying the habitat through development. The protection can be extremely far-reaching. For example, it has been held that the U.S. Army Corps of Engineers did not exceed its statutory authority in denying dam developers a nationwide temporary permit to discharge sand and gravel during the construction of a dam on a tributary of a navigable river.<sup>83</sup> The operation of the dam and the altered water flow would have adversely affected whooping cranes with a critical habitat 250 to 300 miles downstream.

In many areas of the country, the ability to purchase water is crucial to any business enterprise. The Secretary of the Interior's refusal to sell water for municipal and industrial use has been upheld because the Endangered Species Act required the Secretary to give priority to conserving endangered species of fish in a reservoir.<sup>84</sup> The Secretary did not abuse his discretion by determining that there was no excess water to sell and in rejecting an alternate plan for operating a reservoir.<sup>85</sup>

Fee access hunting is a popular alternative use of the land. The Ninth Circuit has held that habitat destruction that could drive endangered species to extinction was a harm to be protected by the Act.<sup>86</sup> The Act defines "harm" to include not only physical injury, but also injury caused by impairment of behavior patterns. The court found that Congress intended the terms to be defined in the broadest possible manner and, therefore, "harm" included habitat destruction.<sup>87</sup> The court sustained an order for the removal of sheep that would destroy the woodland habitat upon which the Palila, an endangered species of bird, depended.<sup>88</sup> The flocks of sheep and goats were maintained on the land by the state for sport hunting. In essence, maintaining nonprotected animals will not be countenanced when their presence will adversely affect the existence and propagation of endangered species.

## VIII. NUISANCE AND PUBLIC SAFETY

### A. Noise

The customary legal response to a nuisance is to seek an injunction to halt the activity. An injunction will not lie for a nuisance that is

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83. *Riverside Irrigation Dist. v. Andrews*, 568 F. Supp 583 (D. Colo. 1983).

84. *Carson—Truckee Water Conservancy Dist. v. Clark*, 741 F.2d 257, 262 (9th Cir. 1984), *cert. denied*, 105 S.Ct. 1841 (1984).

85. *Id.* at 263.

86. *Palila v. Hawaii Dep't of Land and Natural Resources*, 852 F.2d 1106, 1108 (9th Cir. 1988).

87. *Id.*

88. *Id.* at 1110.

common to the public. Generally, a plaintiff must show a special injury to have standing.

Gun clubs and private shooting ranges have been the subject of many actions over the years because of both the noise and the real or perceived danger posed by flying bullets. A finding that these facilities constitute a nuisance must be based on specific facts and circumstances. They have been held not to be nuisances *per se*. The plaintiff has the burden of proving particular circumstances, locations, and surroundings that make the activity a nuisance. The facts must support the contention that there is a real and immediate danger to the public which cannot be compensated by money damages. In complaints about noise, the defense of laches will lie.

In an early Pennsylvania decision, noise produced by guns at a defendant's private trap shooting range was not enjoinable as a nuisance based upon

the locality, the degree of quietness consistent with the standard of comfort prevailing in it, the location of the trap, the distance away of the complainant's house, the degree and quality of the noise, the number of times and the hours of day when the trap is used, the character of such use, the days of the week when it is used, the effect of the noise made thereby upon persons of ordinary sensibility to sound when or near complainant's house, the number of persons concerned in complaining, and all other relevant circumstances disclosed by the testimony.<sup>89</sup>

A 1966 Pennsylvania case held that the unusual noise created by trap, board, and block shoots held at the defendant's gun club which adjoined the plaintiffs' home constituted a nuisance during the summer months when the plaintiffs spent most of their time outdoors entertaining guests.<sup>90</sup> The court further held that these shoots were not a nuisance *per se* and could be held restricted to the winter months.<sup>91</sup>

### *B. Safety*

As early as 1915, laches was not a defense when the danger was caused by bullets going into the public roadway.<sup>92</sup> A preliminary injunction was granted. However, if the club rearranged the traps so that

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89. Roberts v. Clothier, 37 Montg. Co. (Pa.) L. Rev. 165 (1920).

90. Gundel v. Kemnick, 60 Lanc. (Pa.) L. Rev. 116, exceptions dismissed, 60 Lanc. (Pa.) L. Rev. 230 (1966).

91. *Id.*

92. Wolcott v. Doremus, 11 Del. Ch. 58, 95 A. 904 (1915).

bullets no longer hit the public road, the court stated that it would no longer interfere with the operation of the club.<sup>93</sup>

An agricultural location can be a benefit in defending an action against a gun club. In *Oak Haven Trailer Court, Inc. v. Western Wayne Country Conservation Association*, the club was situated in an area that mainly was agricultural and also in which hunting was allowed. The danger allegedly arising from the operation of the shooting range was "a fear of the mind, and not an actual danger . . . ."<sup>94</sup> The court noted that the club employed appropriate safety precautions in building the range. The trial court judge had attended two demonstrations at the range.<sup>95</sup> Sound measurements were taken from the plaintiff's property. In affirming the trial court's decision, the appellate court also held that the noise level did not constitute a nuisance.<sup>96</sup> In reaching its conclusion, the court considered the zoning classification to be an important factor.<sup>97</sup>

## IX. BANKRUPTCY

Chapter 12 of the Bankruptcy Code, Adjustment of Debts of a Family Farmer with Regular Family Income,<sup>98</sup> provides relief for smaller family farms. In the belief that the financial crises facing agriculture would be temporary, Chapter 12 was enacted with a sunset provision to terminate the Chapter on 1 October 1993.<sup>99</sup> A family farmer for the purposes of Chapter 12 is an individual (or an individual and spouse) whose debts do not exceed \$1,500,000.00. At least 80% of this debt must be derived from farming. The 80% figure is computed after the debts on the principal residence have been excluded. Furthermore, more than 50% of the gross income of the individual or couple in the taxable year prior to the year of filing must have been received from farming.<sup>100</sup> A family farm corporation that meets the requirements under the definition may file under Chapter 12 as a family farmer. The relief of Chapter 12 is lost when the definition of "family farmer" no longer is satisfied.

## X. WATER RIGHTS

Traditionally in the western states, water rights have been crucial. They were subject to the range wars of old. They are carefully negotiated,

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93. *Id.* at \_\_\_, 95 A.2d at 908.

94. *Oak Haven Trailer Court, Inc. v. Western Wayne County Conservation Ass'n*, 3 Mich. App. 83, 92, 141 N.W.2d 645, 649 (1966), *aff'd sub nom.*, *Smith v. Western Wayne County Conservation Ass'n*, 380 Mich. 526, 158 N.W.2d 463 (1968).

95. *Id.*

96. *Id.*

97. *Id.* at 91, 141 N.W.2d at 649.

98. 11 U.S.C. § 1201 (Supp. 1990).

99. Family Farmer Bankruptcy Act of 1986, § 302(f), 100 Stat. 3124 (1986).

100. 11 U.S.C. § 101(17).

zealously guarded, and aggressively litigated. As the east coast becomes more crowded, the concern for safe, adequate water supplies has moved east. Whether water rights are part of a real estate transaction or separately negotiated, they generally are restricted to a particular use. Most commonly in rural areas, that use has been irrigation or livestock watering. In areas subject to drought, priorities for water usage again look to use. Many uses will be precluded by rights that have been transferred or secured. And some uses will be less favored under any rationing system.

A thorough title search is the starting point to pick up water restrictions contained in deeds or subject to separately recorded instruments. State and regional environmental agencies also should be consulted. Regional lake and river basin commissions have permit requirements to draw down water for nonagricultural use or for commercial or industrial use. In the alternative, a permit might be required for draw down needs in excess of a certain number of gallons.

## XI. HISTORICAL STRUCTURES AND SITES

Buildings that are registered with the National Register of Historic Places or local historic structure registers are subject to strict guidelines for renovation and modification. Prior approval may be required before so much as a shutter can be replaced. The decision to change a barn or other farm building to a different use easily can bring out the preservationists in full force. Whether or not their cause succeeds, time is lost and expenses are incurred in trying to resolve the matter satisfactorily.

Several states are adopting history codes requiring that before any earth-moving activities take place on a site or before permits are granted for building or other activities, a survey must be performed to determine whether the site is likely to contain historic artifacts. If the result of the survey is positive, a digging first must be allowed to take place. In Pennsylvania, this legislation is contained within the History Code.<sup>101</sup> By the power vested in the Pennsylvania Historical and Museum Commission, the Commission may

[e]xamine, or cause to be examined, research or excavate the occupation or activity sites or areas and the cultural material remains of Native Americans, Colonial American and more recent American cultures in this Commonwealth, under the professional direction of the commission through the techniques of archeology, anthropology and history; . . . .<sup>102</sup>

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101. 37 PA. CONS. STAT. § 101 (Supp. 1990).

102. 37 PA. CONS. STAT. § 302(3) (Supp. 1990).

Currently, at least one hazardous waste landfill project is being held up based upon notification by the Commission to the Pennsylvania Department of Environmental Resources that possible Indian artifacts and significant archeological sites exist in the project area.

## **XII. PERMITS AND LICENSES**

Many of the activities to which agricultural land is suited require permits and licenses that are not needed for the usual agricultural activities. An exhaustive list is impossible because every state and many municipalities have unique requirements. Among the more common requirements in addition to those already cited are:

- regulated shooting ground permits
- propagation permits for game birds and animals
- amusement licenses
- state labor and industry occupancy permits for new construction or renovations to buildings open to the public
- kennel licenses
- food handling licenses
- river basin permits
- sales and use tax licenses
- liquor licenses (even for a one-time event)
- sign permits

## **XIII. CONCLUSION**

The challenge to make a living from the land is age-old. Pioneer farmers struggled with adversities of weather, pestilence, illness, long hours, and lack of money. As enterprising landowners seek creative and innovative ways to make money from the land, attorneys must be both practical and thoroughly knowledgeable in the law of the land. The notion that landowners cannot do as they please with the land is unpopular. The more insistent attorneys become in their message, the more likely the attorneys will be met with anger or even with the loss of clients. The consequences of failing to do that which attorneys are paid to do — advise clients of the legality of their actions and protect clients from adverse consequences — reach beyond any one representation. This job is not for those who need to be liked. The rewards of doing the deal are many. The failure to accept the responsibility of the appropriate role of the attorney is scary. The client who never wanted to hear the message all of a sudden becomes the client who says: "Why didn't you tell me this would happen?"



# Economic and Financial Analysis of Alternative Uses of Agricultural Land

WINSTON I. SMART\*

## I. INTRODUCTION

### A. *The Objective*

Few doubt the need for farmers and other private landowners to open up their lands to the public for recreational and nontraditional purposes. Also, few doubt that this cannot be achieved by government fiat or by armed coercion. Given the imminent desocialization of land in the former Communist countries of Eastern Europe, it is unlikely that American landowners will suffer the fate of the kulaks, that is, be forced to subject their land to national priorities. Because the stick is unavailable, the only alternative is the carrot.

The government, the market, or some other institution must provide efficient incentives to induce the landowner to share his land with the public. Government grants are not likely, given the size of the federal budget deficit, the public debt, and the dearth of funds available from state treasuries. Private philanthropy also appears unlikely; it is difficult to imagine the Rockefeller or Ford Foundation making cash grants to landowners to induce them to share their land with urban and suburban folk. The only other potential source of incentives is the market.

Because economic and financial incentives predominate in a market economy, one must ask whether those incentives exist for the landowner seeking to enter nontraditional enterprises. The objective of this Article is to identify, specify, and analyze the economic and financial issues that confront the farmer or other landowner who wishes to try his hand, and his land, at alternative enterprises that will be socially useful and environmentally safe.

There is an extremely wide range of land-using enterprises that a diversifying farmer may wish to consider,<sup>1</sup> and the possible economic, jurisdictional, and geographic environments increase such diversity. Hence,

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1. Alternative uses of agricultural land include fee hunting, waterfowl, small game and big game hunting, fee fishing, aquaculture, catch-your-own fish farms, petting zoos, bed and breakfasts, hayrides, medicinal herb gathering and production, tree farming, firewood sales, pick-your-own fruit and vegetable fields, campground rentals, and nature trails.

any initial discussion of the economic and financial issues involved must be fairly general. Detailed discussion of a specific enterprise in a particular region of a particular state involves a more focused analysis, something akin to a feasibility study. This is beyond the scope of this Article, which focuses on issues that affect revenue, cost, financing, and taxes, and hence, the profitability and liquidity of these new enterprises. This Article poses the major questions that the landowner should ask and, where possible, suggests some answers. Still conscious of the wide diversity of these new enterprises, the Article offers a few tentative recommendations for farmers who have decided to get involved.<sup>2</sup>

### *B. The Role of Economic and Financial Analysis*

A proper, timely, and thorough economic and financial analysis should give the landowner a relatively realistic picture of the prospects, problems, and possibilities facing the contemplated ventures. The analyst should be neither a San Diego Chicken, that is, an expensive cheerleader, nor a pessimistic Chicken Little. He should "tell it like it is," or it is likely to be, and let the landowner decide whether the rewards are reasonable and the risks worth taking.

All analysis is based on assumptions. The analyst should clearly state the assumptions in advance and not after conclusions and recommendations are found to be unrealistic or unworkable.

## II. ASSUMPTIONS

It is necessary to outline a few assumptions about the farmer or other landowner<sup>3</sup> and the economic situation to be faced. The assumptions are as follows:

- A. The farmer needs new sources of income and additions to net worth, not just new sources of debt and frustration. The alternative enterprise should not be just another shortcut to the bankruptcy court.
- B. The farmer wants net income from the enterprise venture (revenue minus costs and taxes) to be positive, significant, and comparable to what the farmer can earn elsewhere.
- C. The farmer's current or concurrent operation is not a cash cow; it cannot provide investment funds for the new enterprise.

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2. The analysis uses, with a few exceptions, nontechnical language that a non-economist should have no difficulty understanding and explaining to a farmer or other landowner. Also, masculine words refer to both male and female persons.

3. Farmer, landowner, and entrepreneur will be used interchangeably throughout this Article.

- D. The farmer wants cash receipts from the new enterprise to be greater than cash payment obligations from it, thereby providing a positive cash flow.
- E. The farmer has substantial management skills that can be applied to the new enterprise, and the farmer does not have to learn many new skills.
- F. The farmer's participation in the alternative enterprise does not adversely affect his performance in his principal activity. Hence, he can serve two masters.
- G. The farmer can obtain the services of a diligent, competent, and honest attorney and a similarly endowed accountant.
- H. The farmer wants the demand for the new product to be fairly matched with the ability to supply it. No entrepreneur wants the quantity of the product demanded and the price paid for it to be totally out of alignment with the ability to supply it.

### III. IDENTIFICATION, SPECIFICATION, AND DISCUSSION OF ECONOMIC AND FINANCIAL ISSUES

It is important to identify the types of economic and financial issues that will affect the profitability and liquidity of the landowner's new enterprise. Once identified, these issues can be clearly specified and thoroughly analyzed.

#### *A. General Issues*

There are at least two sets of general issues that every entrepreneur faces when deciding whether to start a new enterprise. These issues include the choice of business entity and the location and accessibility of the site chosen to carry on the enterprise.

Regarding the business entity, the landowner must select from the sole proprietorship, general partnership, limited partnership, S corporation, and C corporation. The entrepreneur, with the assistance of an attorney and an accountant, must determine which business entity will realize the greatest level of after-tax net income. These two professionals must study the entrepreneur's individual situation and be aware of the legal and financial costs, benefits, advantages, and disadvantages of each business form. This advice has a cost. Because each landowner will be in a unique situation, any meaningful generalization would be impossible.

Second, the entrepreneur must decide whether the location and accessibility of the site give rise to issues that affect the viability and the profitability of the enterprise. Because buyers of the entrepreneur's product must travel to and from the land and the entrepreneur must transport

items to it, the location and accessibility of the site of the land will be extremely relevant. The resulting disadvantages of travel and transportation cannot be ignored. For example, a perfectly attractive facility might "turn off" some customers if they have to spend too much time getting to and from it. Also, the distance of the land from the nearest urban center must be carefully considered to determine whether location is likely to contribute to relatively low transportation costs, or the opposite, in the new enterprise.

### *B. Tax Issues*

Taxes are a cost of doing business and a major determinant of the incentives or disincentives available to landowners. The farmer is no stranger to difficult and complicated tax issues, and will have to contend with a few more should he decide to open his land to outsiders. Insofar as some taxes become due regardless of profitability, it becomes necessary to examine their incidence and effect before starting any enterprise. The entrepreneur must, with input from an attorney and an accountant, determine as precisely as possible how the establishment and operation of a new enterprise increase tax liability at the federal, state, and local levels.

1. *Federal Taxes.*—At the federal level there are payroll taxes, such as the Social Security tax imposed by the Federal Insurance Contribution Act (FICA)<sup>4</sup> and the unemployment tax imposed by the Federal Unemployment Tax Act (FUTA).<sup>5</sup> These taxes become due and payable regardless of whether any revenue is earned or whether the enterprise is profitable. If the enterprise is profitable, the landowner becomes liable for income tax,<sup>6</sup> and if the landowner is a sole proprietor or a general partner, he becomes liable for self-employment taxes.<sup>7</sup> Of course, the form of the landowner's business will affect the incidence and the amount of taxes paid. The relevant point here is that regardless of the form used, the incentive provided by the market to the farmer or other landowner for sharing land will have to be shared with the federal government, among others. This means that the size of the incentive cannot be too small if it is to induce landowners to share their land.

The landowner will, in all probability, have a family that stands to inherit the property. One concern of potential heirs is that the burden of federal estate taxes<sup>8</sup> might force them to sell the property to pay the

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4. I.R.C. §§ 3101-28 (1989).

5. *Id.* §§ 3301-11.

6. *Id.* §§ 1-3.

7. *Id.* §§ 1401-03.

8. *Id.* §§ 2001-2622.

Government. Section 2032A of the Internal Revenue Code alleviates this concern. This statute allows the decedent's property to be valued at its (farming) income-producing potential, rather than its speculative and higher "market value" if certain conditions are met.<sup>9</sup> Section 2032A(b) and (c) require the land to be in a "qualified use" for minimum periods before and after the landowner's death. Insofar as an alternative use of agricultural land is not a "qualified use" under section 2032A, the land loses its eligibility for a section 2032A valuation.<sup>10</sup> A nonqualified use includes land that is not used as a farm or in another trade or business, or that is used for an enterprise in which the landowner or a family member does not materially participate.<sup>11</sup> For example, leasing land or other property to a hunting club is not considered a trade or business in which the owner materially participates, and hence is not a "qualified use." It disqualifies the property from receiving a favorable estate tax valuation under section 2032A. The property will be taxed at the value reflected by its best and highest use, that is, at its market value. The estate tax liability will thus be higher and the heirs will face an increased possibility of having to sell the property to pay the estate tax. The result will be that a farmer who seeks to share his land with the public may cause his heirs to lose it altogether. This certainly is not good estate planning, and the landowner will need to consult an attorney to determine the likely impact of the alternative enterprise on the tax liability of the estate. One can be sure that potential heirs will not be supportive of the new venture if it may cause them to lose all or a significant part of their inheritance.

2. *State Taxes.*—At the state level, insofar as the state has an unemployment tax, the landowner may be liable for this tax on payments made to employees even before any income is earned. If the state has an income tax, the net income from the venture will be subject to the income tax. This further reduces the profitability of the venture, and is yet another disincentive to the landowner. Also, most states have a sales tax statute that imposes duties on sellers to collect, record, and remit sales tax payments to a state bureaucracy. Insofar as the fulfillment of these legal duties tax the resources of the fledgling venture, it loses more of its attractiveness.

The types of taxes that the venture could be subject to are limited only by the creativity of the state's tax law writers. Entertainment taxes are one possibility. Insofar as these taxes add to the price of the landowner's product or its complements, they may reduce the demand

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9. *Id.* § 2032A(e)(7).

10. *Id.* § 2032A(b)(2).

11. *Id.* §§ 2032A(b)(2), (b)(1)(C)(ii).

for the product, and have a negative impact on the venture's revenue.

3. *County or Local Taxes*.—At the county or local level, property and school taxes add to the landowner's cost of doing business. Barring a substantial cut in the tax rate, the landowner's property taxes will increase when he makes improvements on the land and thereby increases its value. The same can be said for school taxes. These taxes become due and payable regardless of whether any revenue is earned by the venture. Finally, the county and local tax ordinance writers may be as creative as their state counterparts, and may be unhampered by a constitutional provision, such as the Hancock Amendment in Missouri,<sup>12</sup> which limits their ability to impose new levies. The landowner must seriously consider whether the success, the appearance of success, or just the mere appearance of the venture will induce the local taxing authorities to squeeze more from it by way of new types of levies.

### *C. Non-tax Governmental Issues*

Notwithstanding the ideology of the free market, the operation of a business is subject to intense regulation by the state. Businesses must comply with laws and regulations that impose cost-producing duties. The alternative venture, like any other business, will be subject to governmental regulation on a host of issues. This increases the cost of doing business and, hence, the profitability and liquidity of the new enterprise. Such matters may have the capacity to nickel-and-dime the enterprise into unprofitability and to consume a substantial part of the entrepreneur's time. For example, there may be one or more permits or licenses that the entrepreneur must obtain before beginning to operate. Because the permits and licenses cost money, they reduce profits and liquidity. Any analysis of the economic and financial issues facing a new enterprise must therefore take into account the economic costs of complying with duties imposed by government regulations and social legislation. Examples of the latter include worker compensation and unemployment insurance laws, local zoning, and environmental regulations. As with payroll taxes, the costs of complying with these statutes must be met regardless of the earning power of the enterprise.

### *D. Product Market Issues*

Barring government largesse, economic incentives arise from the market. Of primary concern is the product market in which the landowner hopes to sell goods or services. Entrepreneurs should be aware of the significant features of the new market they are seeking to enter and

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12. Mo. CONST. art. X, § 10(c) (amended 1978).

consider how these will affect the ability to sell their products and earn revenue. For example, entrepreneurs must know the nature of the demand they face or will face. Will it be strong or weak, sustainable or passing? Is the demand for the product seasonal or year round? If seasonal, what is the possibility for market creation during the dead season? How many months of the year can the landowner expect a revenue flow? Similarly, entrepreneurs cannot be ignorant of the existence or the nature of other products in that market competing for the consumer's limited dollars. Are they substitutes for or complements to the landowner's product? Entrepreneurs must be aware of the income characteristics of their customers: whether they are high income, middle income, or a combination of both.

The landowner must be aware of competition in the product market. He must consider how easy it is for other new entrepreneurs to enter the market and whether his success will breed a multiplicity of imitating competitors. If there are no legal, financial, or other barriers that make entry into and survival in the market difficult, the landowner will have to learn to deal with competition. Will the market be similar to the traditional competitive product markets in which there are many sellers and little or no control over prices, but yet dissimilar because those markets have certain "safety nets" such as price supports and deficiency payments to reduce the risk of business failure? He must consider the income characteristics of his customers (high, middle, or low-income) and how these affect customers' ability to pay increased prices or pay for new products.

#### *E. Input Market Issues*

The landowner, like every other producer, will need inputs that are not available on the farm; hence, he must enter one or more input markets. These include various goods and services markets, the labor market, and the financial market. The characteristics of these markets affect the prices the entrepreneur pays. These, in turn, affect his cost structure, cost levels, and ultimately the venture's profitability, liquidity, and ability to survive. Any proper analysis must examine these markets to determine how their characteristics will affect the prices he pays. He must also examine the extent to which these input markets are similar to the "old" input markets faced by the landowner when he produced traditional commodities.

The old input markets the farmer faced were generally oligopolistic or monopolistic. They represent one side of the pincers that create the well known "cost-price squeeze" that keeps profits in farming relatively low.<sup>13</sup> Insofar as the landowner must enter input markets as a buyer,

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13. The cost-price squeeze refers to a situation in which the prices paid by, and

he must consider whether he will have to face yet another group of price-makers.

1. *Goods and services markets.*—The entrepreneur needs to ask whether the business will need regular and dependable supplies of goods and services. Can their delivery be arranged in advance? How dependable are the suppliers? What is the cost of supply guarantees? For example, would the entrepreneur have to contract in advance at unfavorable prices in order to be sure of delivery? He also needs to know whether the suppliers are monopolists or oligopolists, and must determine the extent of control they have over the prices they charge and his ability to negotiate lower prices.

2. *Labor markets.*—Insofar as the enterprise needs more labor than the landowner and his family can provide, he must hire labor in the local market. The entrepreneur must have a fair estimate of the labor needs of the business and whether sufficient labor will be available at the time he needs it. It will serve him well to know the seasonal characteristics of that market and the conditions, average wages, and other factors that cause them to increase. Also relevant is the extent to which distance and location affect labor availability, wages, and other labor costs.

3. *Financial Markets.*—The existence and characteristics of financial markets are also relevant to the entrepreneur. Unless the landowner intends to be self-financing, which is unlikely, he must consider whether credit will be available for financing the alternative enterprise, and must locate potential sources of financing for equity, debt, and trade for nontraditional enterprises. Specifically, he must determine whether rural lenders (private and public) are willing to finance new risky ventures in these days of tightened bank regulation after the farm crisis of the eighties and the ever-present savings and loan crisis. Will they be "credit-shy" because of their recent experiences? The entrepreneur must also investigate whether the public lending or guaranty agencies, such as the Farmers Home Administration and the Small Business Administration, will give favorable consideration to the new enterprise on the farm.

#### *F. Financing Issues*

Every business needs to be financed, and the landowner must choose from several alternatives, assuming that they are available. He must also

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hence the costs incurred by, the entrepreneur for his inputs increase at a faster rate than the prices received by him for his product. For the farmer, this is caused in part because he buys his inputs in relatively monopolistic markets and sells his output in extremely competitive markets. He is a price taker in both types of markets. Because profit is the difference between revenue (*i.e.*, *price multiplied by output*) and *cost*, it declines when input prices increase at a faster rate than output prices.

choose between debt financing and equity financing. He must identify all relevant factors that will affect the choice. Assuming that debt money is available, the after-tax cost of money and the conditions likely to be imposed by a potential lender will be major considerations. In turn, the terms of these credit arrangements will depend on the availability and willingness of lenders and the existence of less risky and more attractive investment opportunities on and off the farm. These alternative investments also determine the amount of capital likely to be invested, as well as the amount of control a potential investor might demand as a condition for contributing to the venture.

Careful financial planning is also necessary to maintain liquidity in the enterprise. Failure to plan will prevent the enterprise from being able to pay its debts as they become due. Unless he can obtain the required cash inflows from another source, the landowner will face impatient creditors. The assets and liabilities structure of these enterprises, specifically their potentially low current assets and high current liabilities, will produce a negative cash flow in some periods. The landowner must be aware of the implications of this and must have the necessary credit arrangements in advance to correct it. Failure to do so may result in the entrepreneur's qualifying for a bankruptcy petition.

#### *G. Control and Governance Issues*

The enterprise must be managed and directed by some policy-making and decision-making individual or group. Insofar as the landowner must share management and control with others, limits are imposed on his power to run the enterprise. These issues become particularly relevant when the entrepreneur must seek outside financing, and the lenders or investors impose conditions on the use of those funds. For example, financing sources usually will demand some control over the structure and operation of the enterprise. The extent and enforcement of such control and its effect on the profitability of the enterprise must be examined. If there is insider control by off-farm "outsiders," the landowner might be reduced to a worker without management power or control. One must ask whether a landowner would be willing to subject himself to this if the principal beneficiary is the public.

#### *H. Cost Issues*

Any analysis of alternative land use should look at costs before revenue because costs are more certain to be incurred than revenue is likely to be earned. The alternative use of agricultural land may take many forms. Each one will have its own unique set of costs. Certain categories of costs, however, will be common to every enterprise, and the landowner should be aware of them and their prominence in the

cost structure of his enterprise. Specifically, there will be developmental fixed costs, recurrent fixed costs, semi-variable costs, and variable costs.

Developmental fixed costs are incurred when land is developed for use in a given enterprise. It consists of a one-time expenditure that must be made before the improved land can be used to produce the new item. Hence, before a dime of revenue is received, developmental costs must be paid either with cash or with interest-bearing debt. Because developments to land usually last for more than one year, their cost, including the cost of financing, should be allocated to the fixed costs in the years in which they are used.

Developmental costs must be incurred before the venture makes a single dollar of revenue. Such items include legal fees, the cost of obtaining licenses and permits, and construction costs. Land development usually is not a particularly inexpensive exercise, and the possibility of cost overruns is very real. Hence, it is important that these costs be identified and estimated as precisely and as early as possible to avoid an unfinished development with no funds to complete it. The entrepreneur also must have some estimate of the length of the development's productive life and its maintenance costs. These will significantly affect the size of the entrepreneur's recurrent fixed costs and variable costs. A long-life, low-maintenance development will have a smaller impact on recurrent fixed and variable costs than will a short-life, high-maintenance development. Different types of alternative land-using enterprises require different types of developments.

Recurrent fixed costs are incurred in every production period and are the same regardless of the level of output. As with all costs, the entrepreneur needs to minimize them, but attempts to do so could result in a small "plant size," low levels of production and hence, low levels of revenue. These, in turn, affect profitability and liquidity. The sum of each year's developmental fixed costs and recurrent fixed costs equals the enterprise's total fixed costs for that year. Regarding recurrent fixed costs, the entrepreneur should have a reasonable estimate of not only their absolute size, but their share in total costs.

In a land-based enterprise, fixed costs are likely to be fairly high, both absolutely and relatively. Relatively high fixed costs in an enterprise usually imply that throughput must be relatively high before the enterprise reaches the "breakeven point," the level of output at which total annual revenue equals total annual cost. Given the high probability that most alternative enterprises might be seasonal businesses, the entrepreneur should consider the possibility that he might never arrive at the breakeven point. This means that he always will be in a "loss" position in which there are no financial incentives.

Variable costs are those that change with the level of output. As output increases and the use of variable inputs increases, variable costs

must increase. It is in their management that the entrepreneur may have the greatest flexibility in controlling costs.

Variable costs represent the one area in which the landowner may have some control after he has started a business. Insofar as he can buy more or less of a good or service or substitute a less costly for a more costly item, he can exercise some control over his costs. If he buys a relatively necessary item from a monopolist or an oligopolist, however, he lessens his control. Given the wide diversity of alternative enterprises that use agricultural land, it is difficult to say whether this control over costs can ever be significant.

The entrepreneur also should be sensitive to the importance of energy costs, transportation costs, advertising and marketing costs, and professional fees. The timing of these costs and their relationship to the seasonality of the business must also be considered.

The significance of energy costs cannot be overemphasized. In addition to a firm's direct expenditures, these costs also are reflected in the prices of non-energy input purchases. The entrepreneur must determine his cost structure's sensitivity to changes in energy costs. If sensitivity is high and if energy prices appear to be moving upward steadily, the entrepreneur will have almost zero control.

Because the entrepreneur will need the services of an accountant, an attorney, and other professionals whose services are fairly high-priced, he must determine what control, if any, he has over the rate charged and the hours billed. The absence of controls might produce high invoices from even the most conscientious professionals. These make the attainment of the "breakeven point" and profitability even more difficult.

Advertising and marketing efforts attempt to increase the revenue flow of the business. They carry a cost, however. Given the importance of these efforts to the success of any business, the decision is not whether the entrepreneur should use them, but what share of his total budget he should devote to them.

Insofar as the rural operation needs transportation services, the entrepreneur must decide whether to buy them or provide them himself. If he chooses the latter, he must decide whether to buy or lease the necessary capital equipment. Each alternative has its own financing implications. Again, given the wide range of land-using enterprises and situations, it is difficult to say which alternative is generally best.

There are some types of costs that are a hybrid of fixed and variable costs. They contain a fixed element and a variable element that are inseparable. These types are referred to as "semivariable costs," and give the entrepreneur some flexibility, something less than in the case of variable goods. When these items are relatively small, they do not merit much concern. As they become larger, however, the entrepreneur must take a closer look at them. A good example is liability insurance

that has a fixed minimum payment and a variable portion dependent on the level of business revenue. This arrangement has serious implications for the profitability of the enterprise and the incentive it provides to the landowner. It amounts to giving one's insurer a "super-equity" interest in the business. Because an equity interest holder receives a fraction of the *net* income of the enterprise and the insurer receives a share of the *gross* income of the business regardless of its cost, the insurer is much better off than a normal equity holder. Hence, the term "super-equity" interest. The landowner needs to think carefully about whether he wants to enter a business that requires not only compulsory payments to three different levels of government before he has earned one penny, but also that he give a super-equity interest to his insurer.

Regarding each category of cost, the entrepreneur must have some idea of the "total" and their "average" level per unit of output. It is essential that the entrepreneur have, before starting operations, some estimate of total fixed costs per year, average fixed costs per unit of output, total variable costs per year, average variable costs per unit of output, total combined costs for the year, and average total combined cost per unit of output. If this last figure exceeds or is too close to the price he intends to charge, then he can be certain that his operation will be facing some unprofitable periods. It would be folly to incur substantial costs only to discover that the average cost of production far exceeds what anyone would reasonably pay for the good or service being offered.

The entrepreneur must be wary of the seasons' effect on his operations and, consequently, on his cash flow. If the farmer's operations are seasonal, he will face several months of zero revenue and positive costs. Appropriate financing arrangements must be made to avoid defaulting on due debts and the legal consequences of doing so.

### *I. Revenue Issues*

The amount, timing, and sensitivity of revenue and the factors that affect them produce issues that are relevant to the viability of any business. In its simplest terms, revenue is the product of the good's price times the quantity of the good sold. Prices and quantity sold are therefore two vital variables that the entrepreneur must examine carefully. Revenue is at the heart of the market incentive. Without a certain minimum level, there can be no profit. The entrepreneur in an alternative enterprise should be aware of certain factors that influence the level of the revenue his enterprise earns. These factors are the uniqueness of the product, its price elasticity of demand, its cross-elasticity of demand, its income elasticity of demand, its price elasticity of supply, its price and pricing, and its output level.

Using "difference" as the criterion, every product is situated on a continuum ranging from the unique and highly differentiated to the homogeneous and fungible. A unique product allows the entrepreneur to charge a higher price than a similar nonunique commodity would bring. The process of product differentiation makes products more unique and less homogeneous so that the producer can ask a higher price. The entrepreneur considering an alternative employment for his land must consider whether his alternative product is more or less unique, whether it can be obtained only at his location or at a thousand other locations, and whether he can charge a differential for this uniqueness. The ability to charge a differential enhances the revenue of the enterprise and makes the achievement of profitability and maintenance of liquidity more likely.

The uniqueness of the entrepreneur's product and its location will be a major determinant of his revenue. If neither the location nor the product is particularly unique, the entrepreneur must consider the possibility that nearby landowners will enter the market, offer competing alternatives, and bid away his customers. If this is a real possibility, it limits the amount of flexibility available to the entrepreneur and hence his revenue. One area of limited flexibility is pricing.

Related to product uniqueness is the economics concept of price elasticity of demand.<sup>14</sup> Price elasticity of demand is based on the theory that the quantity demanded of a product is affected by the price charged for it and by several other factors. Price elasticity of demand seeks to measure the rate of change in the quantity demanded over a given time period in response to a unit change in the price of the commodity, holding all other factors that affect quantity constant.<sup>15</sup> It is a measure of consumer response to changes in the price of the commodity. The demand for a particular good (at a particular combination of price and quantity demanded) is either elastic, unit elastic, or inelastic, and each category has different implications for consumer expenditure and hence, revenue.<sup>16</sup>

In the case of elastic-demand goods, if the producer increases the price, revenue will fall.<sup>17</sup> If he decreases the price, revenue will increase.<sup>18</sup> The opposite holds with inelastic-demand goods: price cutting decreases revenue and price increases increase revenue.<sup>19</sup> In the case of unit elas-

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14. See D. McCLOSKEY, *THE APPLIED THEORY OF PRICE* 136-39 (1985); W. NICHOLSON, *MICROECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS* 188-90 (4th ed. 1989).

15. D. McCLOSKEY, *supra* note 14, at 136; W. NICHOLSON, *supra* note 14, at 188.

16. D. McCLOSKEY, *supra* note 14, at 139; W. NICHOLSON, *supra* note 14, at 188-89.

17. D. McCLOSKEY, *supra* note 14, at 139; W. NICHOLSON, *supra* note 14, at 190.

18. D. McCLOSKEY, *supra* note 14, at 139; W. NICHOLSON, *supra* note 14, at 190.

19. D. McCLOSKEY, *supra* note 14, at 139; W. NICHOLSON, *supra* note 14, at 190.

ticity, any change in price produces a zero change in revenue.<sup>20</sup> Revenue is the same at all price levels, and the entrepreneur has no revenue incentive to change prices.

The price elasticity of demand of the landowning entrepreneur's new product will be either elastic, inelastic, or unit elastic. Because it will be a new product, he will not have the benefit of other producers' experience, and will have to make an intelligent guess. If it is a unique product provided at a unique location, the demand should be relatively inelastic, but if it is not a necessity and there are substitutes, the demand should be relatively elastic. Given the wide range of alternative products available from enterprises using agricultural land, it is difficult to make a general statement. Each entrepreneur must observe the conditions in his own situation and make an intelligent guess. He can then use this guess to guide his pricing decisions. The question will be at what level prices should be set in order to obtain the market incentive, to realize revenue levels high enough to make a profit, and at the same time meet the competition from alternative local, regional, national, and international attractions.

The goods and services produced by the entrepreneur will be both substitutes and complements to existing and new goods and services. Because all goods ultimately compete for the consumer's limited income, changes in the prices of complements and substitutes affect the quantity demanded of a good. This relationship is described by the concept of cross-price elasticity of demand.<sup>21</sup> If two goods are substitutes, an increase in the price of one is expected to lead to an increase in the quantity demanded of the other; if they are complements, an increase in the price of one is expected to lead to a decrease in the quantity demanded of the other.<sup>22</sup> An entrepreneur thus needs to know what goods and services are complements to or substitutes for his product and the extent to which price changes in the latter affect the quantity demanded of his product. Ultimately, the entrepreneur's revenue will be affected by price changes in all goods.

Energy will, in all probability, be a necessary complement for the enjoyment of the product. The landowner must expect rising energy prices to reduce the demand for his product and lower energy prices to have an opposite effect. Because the enjoyment of substitute products is also dependent on expenditures on energy, however, the change in sales will not be as great. The point worth noting is that any investment

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20. D. McCLOSKEY, *supra* note 14, at 139; W. NICHOLSON, *supra* note 14, at 190.

21. See W. NICHOLSON, *supra* note 14, at 190-91; R. POLKINGHORN, *MICRO-THEORY AND ECONOMIC CHOICES* 107 (1979)

22. W. NICHOLSON, *supra* note 14, at 191; R. POLKINGHORN, *supra* note 21, at 107.

made by the landowner to attract business could be "held hostage" by energy price movements. The landowner should be aware of this before he commits himself to an enterprise that, if unsuccessful, might result in the loss of his land. Taking the analysis further, both uniqueness and elasticity of demand affect the price and the pricing decisions of the entrepreneur who must decide at what level prices must be set, when they should be changed, and by how much they should be changed.

Another relevant elasticity concept is the income elasticity of demand, which measures the percentage change in quantity demanded of the product per unit change in consumer income, with all other factors affecting demand held constant.<sup>23</sup> As consumers' income rises, they may spend less of their increase in income on the product, as in the case of food, or more of their increase in income on it, as in the case of recreation and entertainment. This result has implications for producers in the two types of industries. In the first type of industry, with decreased (proportional) consumer spending, it is obvious that the expansion possibilities of the industry, and the firms, are rather limited. In the second, the expansion possibilities are more favorable.

Income elasticity of demand suggests mixed prospects for some alternative land-using enterprises. Insofar as the landowner's enterprise is associated with a high level of discretionary income in the hands of consumers, he can expect an increase in business as per capita income increases. Yet, as income becomes more unevenly distributed among the population and relatively fewer consumers are able to buy his product, the increase in business will be dampened.

Because revenue is also determined by the level of output sold, the entrepreneur must determine his desired or optimum output level. Because output is dependent on the resources invested in the enterprise and the level of costs incurred, the entrepreneur must have some idea of the minimum level necessary to make a profit in order to realize the economic incentives from devoting his resources to production for the public. It is necessary that output be relatively stable, dependable, and predictable. The alternative entrepreneur must attempt to identify the physical and other constraints on the level of output, such as the size of facilities, weather variables, crowd control, vandalism control, and local regulations. Because increases in demand usually bring increased revenue, the entrepreneur should be aware of his ability to meet an unexpected surge in demand.

The elasticity of supply is a concept that measures the response of quantity supplied to changes in the price of the product or in other

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23. See W. NICHOLSON, *supra* note 14, at 190; R. POLKINGHORN, *supra* note 21, at 108.

factors.<sup>24</sup> It is based on the theory that the price received for a product, along with other factors, affects the amount produced. Hence, price elasticity of supply measures the rate of change in quantity supplied per unit change in the price of the product, with the other factors held constant.<sup>25</sup> The concept measures the extent to which a price change acts as an incentive to make a producer increase or decrease output.

The entrepreneur must have some estimate of his price elasticity of supply because if the new enterprise is a price taker, it must respond to prices set by the market for the same or similar products. It is important for the entrepreneur to know, if only tentatively, the extent to which his enterprise can respond to changes in the market price of its product or substitutes. This knowledge will prevent the landowner from producing commodities that he can only sell at a loss or from failing to produce commodities for which consumers are willing to pay remunerative prices. In either case, he forgoes a profit opportunity and completely misses the market incentive that is supposed to reward him for sharing his land with the public.

#### *J. Miscellaneous Issues*

The entrepreneur must make allowances for personal events and characteristics that could affect his ability to manage the enterprise and make it profitable. These would include illness, personal emergencies, personal temperament, and ability to deal with strangers, to name a few. Also, he must be aware that the government, at any level, could at any time impose laws or regulations that might completely upset even the best-planned efforts to run a successful business.

#### *K. Comparing Competing Alternatives*

A landowner may have several possible alternative enterprises from which to select. A selection must be made only after all the issues affecting and affected by each enterprise are analyzed and a conclusion is reached as to which is the "best" choice. A choice must take into account the objectives and resources of the landowner and the assumptions made earlier.

### IV. SUMMARY AND CONCLUSIONS

A landowner seeking to convert his land to alternative profitable uses must consider a wide range of economic and financial issues before

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24. See W. NICHOLSON, *supra* note 14, at 408-09; E. MANSFIELD, *MICROECONOMICS* 29 (1979).

25. W. NICHOLSON, *supra* note 14, at 408-09; E. MANSFIELD, *supra* note 24, at 29.

making a final decision. Failure to do so might put him in a situation of high costs, high taxes, numerous competitors, and weak demand for his product. He might also face a new cost-price squeeze situation, not unlike the one traditionally faced by agricultural producers. Worse, he will not have the safety net of agricultural programs that have allowed some farmers to survive the old cost-price squeeze. In order to avoid "going back to the future," the farmer must look at the economic and financial variables very carefully.

#### V. TENTATIVE RECOMMENDATIONS

In spite of the risks involved, there will always be some entrepreneurs who, for one reason or another, want to enter an industry. They can benefit from some general recommendations to reduce costs and taxes, increase throughput, and prevent product prices from falling. Because of the wide range of alternative uses of agricultural land, it is not possible to offer specific and detailed recommendations.

It is important that the farmer not overlook any opportunity for cost reductions that do not adversely affect the quantity and quality of his output. One fruitful area would be purchasing from suppliers who do not have significant market share or control, who are not price makers, and who are willing to negotiate prices. This purchasing would allow the landowner to obtain better terms and possibly lower prices.

Given the great significance of the wide range of tax levies, he must, like all other entrepreneurs, adopt strategies that reduce his taxes at every level and must rely heavily on his attorney and accountant. Given the wide range of combinations of possible enterprises, business forms, and tax situations, it is difficult to offer specific tax reducing proposals. One is tempted to mention a strategy of lobbying federal and state tax writing authorities to mitigate the burden of taxation faced by those who wish to pioneer these socially useful and non-polluting uses of agricultural land. Lobbying is not cost-free, however, and it is doubtful whether these new enterprises will have the funds to do so.

Probably the most promising strategy for the entrepreneur is market development. The landowner must adopt a strategy to inform the world about his product, seek out those most able to buy the product, and encourage them to buy it in quantities large enough to make his enterprise profitable and liquid. Advance contracting offers some possibilities. The landowner could sell his product in advance of the season. This would, if successful, increase his revenue and his liquidity. Also, it would assist him greatly in financial planning. Similarly, the entrepreneur would do well to offer his product to group buyers such as schools, day care centers, senior citizen centers, churches, clubs, civic groups, unions, and corporations. This is generally more efficient than dealing with one buyer at a time.

The entrepreneur would do well to use some of the institutions of the existing travel and leisure industry. One of these is the travel agent. Travel agents and other middlemen have the access to consumers that the entrepreneur does not. They can at least make the consumer aware of the existence of the service and allow him to choose between it and other traditional alternatives, such as a trip to a theme park or to a foreign country. For example, a stay at a hunting preserve might be offered as an alternative to a tropical cruise. Of course, the entrepreneur would have to offer some financial incentive to the travel agent and this might take the form of a discount or a fee. By discounting large numbers of "tickets" to travel agents, the entrepreneur can receive the benefit of group contracting and access to a much wider market of buyers.

The issuing of coupons is yet another device for reaching a wider market. Although it does not give the entrepreneur the same degree of control as do sales to groups or travel agents, it does produce contact with thousands of potential buyers, some of whom might be interested in staying at a rural bed and breakfast or experiencing a bit of the farming lifestyle. To an entrepreneur with relatively high fixed costs, relatively high current liabilities, and relatively few current assets, this option, like all revenue raising devices, should not be ignored.

The entrepreneur must also consider the option of discounting to the general public. This might be extremely necessary during a period of low demand, and there may be consumers who might be willing to purchase, for a discount, in the off season.

The possibility of joint selling by entrepreneurs in similar alternative businesses should also be considered. Entrepreneurs could combine and appoint a number of selling agents, such as travel agents, who would allow consumers to choose from different alternative enterprises. Hunting or fishing enthusiasts could then have a much larger selection of possible sites offered by entrepreneurs.

Like all other sellers, the entrepreneur runs the risk of the price of his product falling to unprofitable levels at the time of actual sale. This could be detrimental, especially if it occurs after the entrepreneur has done his financial planning on an assumption of higher product prices. He must therefore have strategies for avoiding this risk or of passing it on to someone better able to bear it. One possibility is to negotiate advanced sales of the product at fixed prices or to contract with large organizations on similar terms. Also, his block sales to travel agents could be negotiated at fixed rates.

One final conclusion needs to be drawn. If the market is the only practical source of incentives to induce the landowner to share his land with the public, if the market incentive has to be shared with federal, state, and local governments, among others, and if the market is fraught

with substantial uncertainties, then one must ask if the market can ever provide a realistic incentive. In the absence of a realistic incentive, and in the absence of government compulsion, the prospects of a landowner choosing an alternative use for his agricultural land and, hence, of greater public access to private lands, are not terribly overwhelming.



# **Landowner or Occupier Liability for Personal Injuries and Recreational Use Statutes: How Effective is the Protection?**

JOHN C. BECKER\*

## **I. INTRODUCTION**

At the time the first recreational use statutes were adopted in the late 1950s and early 1960s, the generally prevailing view of a landowner's duty to those entering his or her property varied according to the injured party's status in relation to the landowner. Three classifications describing that status developed. The first classification is that of trespasser, who is a person on the land without the owner's express or implied permission. A landowner has a minimal obligation to a person classified as a trespasser. Usually, this includes the duty to avoid intentional, willful, or wanton conduct that injures the trespasser or damages his property.<sup>1</sup> The second classification is that of licensee. A licensee is one with permission to enter the premises. The owner owes a duty to avoid willful, wanton, or reckless conduct that injures the licensee, and to warn the licensee of defects or dangerous conditions that exist on the premises.<sup>2</sup> The third classification is that of invitee. An invitee is an individual who is either expressly or impliedly invited onto the owner's land to pursue some commercial or other interest of the owner and the entering individual. Landowners owe a duty to invitees to make their premises reasonably safe for entry. Therefore, a landowner must take reasonable care to inspect the premises to discover actual conditions and latent defects that pose a threat to the invitee.<sup>3</sup> Once discovered, a landowner has a further responsibility to either repair the defects or warn the invitee of their existence.<sup>4</sup>

In light of the law, landowners faced pressure from others who wanted to use the owner's land for recreational activities, particularly

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1. *See, e.g.*, *Graham v. Sky Haven Coal, Inc.*, 386 Pa. Super. 598, 563 A.2d 891 (Pa. Super. 1989), *appeal granted*, 575 A.2d 566, 568 (1990); Annotation, *Modern Status of Rules Conditioning Landowner's Liability Upon Status of Injured Party as Invitee, Licensee, or Trespasser*, 22 A.L.R. 4TH 294 (1983) (superceding 32 A.L.R.3D 508 (1970)).

2. 62 AM. JUR. 2D *Premises Liability* §§ 159-61 (1990).

3. *Id.* §§ 136-37.

4. *Id.*

hunters and fishermen. Applying the "status equals duty owed" approach resulted in imposing on owners and occupiers a duty to warn users of the hazards that might be encountered on the property. To a landowner with much land, complying with the duty to warn could be expensive, and complete compliance might be difficult to achieve. A second concern involved classifying a land user as a licensee simply because an owner gave implied permission to use the property, as when a landowner discovers a trespasser on the property, but takes no steps to expel the trespasser from the land. Does this failure to expel the trespasser constitute implied permission to remain on the land?<sup>5</sup> Must a landowner conduct a seven day, twenty-four-hour per day patrol to keep unwanted people off the property?

Legislatures recognized the potential liability of owners and occupiers for injuries that occur to others using their land. In response, several acts were passed to modify the traditional rules for determining liability. In Pennsylvania, for example, the Act of September 27, 1961, P.L. 1969, protected owners of agricultural land or woodlands from personal injury liability to hunters or fishermen on the owner's property, unless the injury was deliberately or willfully inflicted by the owner. Concerns about potential liability, arising from owners and occupiers willing to make their land available for recreational use activities, should be addressed.

During the 1960s, dramatic changes took place in the form of growing criticism of the status-equals-duty-owed approach. *Rowland v. Christian*<sup>6</sup> challenged the idea that a landowner's duty should vary with the injured party's status at the time injury occurred. Others criticized the arbitrary and fleeting nature of the status determination.<sup>7</sup> The landowner's status as a protected class also changed as issues of personal safety became

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5. See, e.g., *Mann v. Des Moines Ry. Co.*, 232 Iowa 1049, 7 N.W.2d. 45, 51 (1942) (acquiescence by railroad company in allowing public use of railway crossing establishes status of licensee, not trespasser).

6. 69 Cal. 2d 108, 70 Cal. Rptr. 97, 104, 443 P.2d 561, 568 (1968), *superceded* by statute, as stated in *Perez v. South Pacific Transp. Co.*, 218 Cal. App. 3d 462, 267 Cal. Rptr. 100 (1990).

7. See, e.g., *Antonace v. Ferri Contracting Co.*, 320 Pa. Super. 519, 467 A.2d 833, 839 (1983):

A canvasser who comes on your premises without your consent is a trespasser. Once he has your consent, he is a licensee. Not until you do business with him is he an invitee. Even when you have done business with him, it seems rather strange that your duty towards him should be different when he comes up to the door from what it is when he goes away. Does he change his color in the middle of the conversation? What is the position when you discuss business with him and it comes to nothing?

(quoting Comments of Lord Justice Denning in *Dunster v. Abbott*, 2 All E.R. 1572, 1574 (C.A. 1953)).

more important when compared to issues of providing greater flexibility for landowners.<sup>8</sup> Courts also questioned whether such emphasis on status led to harsh results and wasted effort by focusing on the injured party's status rather than the landowner's conduct in relation to the injured party.<sup>9</sup> The common law classifications became increasingly difficult to apply. Subtle refinements blurred the distinctions, leading to confusion and the creation of narrow exceptions.<sup>10</sup>

Two alternative theories developed among those jurisdictions that chose to abandon the status-equals-duty-owed approach. One alternative theory simply asks, did the landowner exercise reasonable care in the maintenance of the property in view of the probability and foreseeability of injury to others who used the owner's premises?<sup>11</sup> Under this concept, all three classifications are replaced with but a single inquiry about reasonable care. Status, although not determinative of the duty owed, is not completely irrelevant. The degree of reasonable care an owner exercises toward an unknown, intentional trespasser is probably significantly less than the reasonable care exercised toward a business invitee. However, liability determinations are decided on a case-by-case basis under this "reasonable care under the circumstances" approach.

Some jurisdictions favored doing away with both licensee and invitee status, but were reluctant to completely eliminate the status of trespasser. In those jurisdictions, the status of the injured person as a trespasser is only one element among many considered in determining an owner's liability under the ordinary standards of negligence.<sup>12</sup>

The concept of encouraging private landowners to make their land available to the general public began to develop in this context. In its 1965 Suggested State Legislation, the Council of State Governments proposed the adoption of a model act to limit an owner or occupier's liability for injury occurring on the owner's property.<sup>13</sup> The Council noted that every reasonable encouragement should be given to private owners who are willing to make their land available to the general public without charge.<sup>14</sup> If an owner treats access to land on a business or

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8. *Smith v. Arbaugh's Restaurant, Inc.*, 469 F.2d 97, 101 (1972).

9. *Mile High Fence Co. v. Radovich*, 175 Colo. 537, 541, 489 P.2d 308, 311-12 (1971).

10. *Rowland*, 70 Cal. Rptr. at 102, 443 P.2d at 566.

11. *Id.* at 104, 443 P.2d at 568.

12. *Peterson v. Balach*, 294 Minn. 161, 174, 199 N.W.2d 639, 647 (1972). At the present time, a majority of states follow the traditional common-law approach, while 11 states follow the rule of reasonable use, and seven states have modified the rule to apply a special rule in the case of an injured trespasser. *Id.*

13. Council of State Governments, *Public Recreation on Private Lands: Limitations on Liability*, 24 SUGGESTED STATE LEGISLATION 150 (1965) [hereinafter 1965 MODEL ACT].

14. *Id.*

commercial basis, there is little reason to treat the owner differently from other business owners.<sup>15</sup>

In 1979, the National Association of Conservation Districts and others<sup>16</sup> commissioned W. L. Church, Associate Dean of the University of Wisconsin Law School, to conduct a study of landowner liability and trespass laws.<sup>17</sup> The study's scope went beyond civil liability concepts and considered the criminal law question of trespass to another's land.<sup>18</sup> The study resulted in a proposed refined model act, incorporating a landowner's concerns about liability protection for injuries occurring on the property with the sensitive issue of maintaining a landowner's ability to control his or her own premises.<sup>19</sup>

### *Purpose*

The purpose of this Article is to examine how legal systems throughout the United States have applied the concepts and issues raised by adoption of recreational use statutes. This Article will highlight the key issues that affect applicability of the acts to specific situations and the extent of actual protection afforded to landowners. This Article will then examine and evaluate significant suggestions for amending or modifying recreational use statutes.

## II. COMPARISON OF THE 1965 AND 1979 MODEL ACTS

### *A. The 1965 Model Act*

The stated purpose of the 1965 Model Act was to encourage owners to make land and water areas available to the public for recreational purposes by limiting owner's liability toward persons who enter their property for such purposes.<sup>20</sup> Protection from liability was extended to holders of a fee ownership interest, as well as to tenants, lessees, occupants, and persons in control of premises.<sup>21</sup> The Act benefitted roads, waters, watercourses, private ways and buildings, structures, and machinery or equipment attached to realty.

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15. *Id.*

16. Others include the International Association of Fish and Wildlife Agencies, the National Rifle Association, the National Wildlife Federation, and the Wildlife Management Institute.

17. W.L. CHURCH, REPORT ON PRIVATE LANDS AND PUBLIC RECREATION 6 (1979) [hereinafter CHURCH REPORT].

18. *Id.*

19. *Id.*

20. 1965 MODEL ACT, *supra* note 13, § 1.

21. *Id.* § 2.

Recreational activities within the purview of the 1965 Model Act include hunting, fishing, swimming, boating, camping, picnicking, hiking, pleasure driving, nature study, water skiing, water sports, and viewing or enjoying historical, archeological, scenic, or scientific sites.<sup>22</sup> In describing the protection afforded owners and occupiers, the Act states that an owner or occupier owes no duty of care to keep premises safe for entry or use by others for recreational purposes, or to give any warning of dangerous conditions, uses, structures, or activities to persons entering the premises for such recreational purposes.<sup>23</sup> If an owner directly or indirectly invites or permits any person to use the property for recreational purposes without charge, the owner does not assure that the premises are safe for any purpose, nor confer the status of licensee or invitee on the person using the property, nor assume responsibility for or incur liability for any injury to persons or property caused by any act or omission of persons on the property.<sup>24</sup>

The protection afforded by the 1965 Model Act is not intended to be absolute.<sup>25</sup> Should injury to users of the property be caused by the willful or malicious failure to guard or warn against a dangerous condition, use, structure, or activity, protection of the Act is lost. Likewise, if the owner imposes a charge for use of the property, protection is lost.<sup>26</sup> If an owner leases land to a state or local government, any consideration the owner receives for the lease is not deemed to be a charge. Therefore, unless the owner and state government agree otherwise in writing, the protection of the Act would be extended to the owner. Within the context of the 1965 Model Act, "charge" includes any admission price or fee asked in return for invitation or permission to enter or go up on the land.<sup>27</sup>

#### *B. Proposed Model Act of 1979<sup>28</sup>*

W. L. Church's 1979 study of landowner liability and trespass laws noted two deficiencies: (1) Liability law is generally too protective of users, and injured persons have been granted recoveries so often that landowners are discouraged from opening their land for recreational use;

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22. *Id.*

23. *Id.* § 3.

24. *Id.* § 4.

25. *But see OHIO REV. CODE ANN.* § 1533.181 (Baldwin 1984); *McCord v. Ohio Div. of Parks & Recreation*, 54 Ohio St. 2d 72, 375 N.E.2d 50 (1978); *IDAHO CODE* § 36-1604 (Supp. 1990).

26. 1965 MODEL ACT, *supra* note 13, § 6.

27. *Id.* § 2.

28. CHURCH REPORT, *supra* note 17, app. D [hereinafter 1979 PROPOSED MODEL ACT].

and (2) both laws are too complex and confusing to be either predictable or understood.<sup>29</sup> As a result, landowners are reluctant to make their land available, and the public has fewer recreational choices. Criminal trespass laws are also practically unenforceable. For example, landowners often are unable to stop trespassers or to otherwise identify persons who violate their privacy. Calculating damages is difficult, and payment of fines may not deter future misconduct.<sup>30</sup> Because of their many different forms, criminal trespass statutes create doubt and ambiguity about the type of conduct that is prohibited. Areas of ambiguity include: (1) Who is subject to the criminal sanction — any user, or only those who enter with a particular intent? (2) Does the statute apply only when the owner or occupier of the premises notifies the public that private land is not available for public use? (3) If notice is required, will posting satisfy the requirement? (4) What kind of posting by the owner or occupier will satisfy the requirement? (5) Is special language or size required?

In the 1979 Proposed Model Act, "land" includes all real property, land, and water, and all structures, fixtures, equipment, and machinery thereon.<sup>31</sup> "Owner and occupiers" include individuals, entities, or governmental agencies that have an ownership or security interest or lease, or right of possession in the land.<sup>32</sup> "Recreational uses" include any activities undertaken for exercise, education, relaxation, or pleasure on land owned by another.<sup>33</sup>

The 1979 Proposed Model Act offers protection similar to the 1965 Model Act. Under the 1979 Proposed Model Act, an owner of land does not owe anyone a duty of care to keep the land safe for recreational use. Likewise, the owner has no duty to give any general or specific warning with respect to a natural or artificial condition, structure, personal property, or activity thereon.<sup>34</sup> Landowners who directly or indirectly invite or permit others to use their land for recreational use without charge do not thereby extend assurance that the premises are safe for any purpose regardless of whether the land is posted. They do not confer the invitee status, or any other status that requires a duty of special or reasonable care. Finally, they do not assume responsibility or liability for injury caused by a natural or artificial condition, structure, or personal property on the premises, or assume responsibility for damage caused by the act or omission of another.<sup>35</sup>

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29. *Id.* at 6.

30. *Id.* at 16.

31. *Id.* § 2.

32. *Id.*

33. *Id.*

34. *Id.* § 3.

35. *Id.* § 4.

The protection afforded by the 1979 Proposed Model Act is not absolute. Owners and occupiers of land remain liable for malicious, but not merely negligent, failures to guard or warn against ultrahazardous conditions, structures, personal property or activities actually known to the owner or occupier to be dangerous. They remain liable for injuries suffered by persons who pay a charge to enter the land. Finally, they remain liable for injuries suffered by children younger than twelve years of age who are injured on land in an urban or residential setting if liability would otherwise be imposed under the doctrine of attractive nuisance as defined by section 339 of the Restatement (Second) of Torts.<sup>36</sup>

The most significant departure from the 1965 Model Act made by the 1979 Proposed Model Act is in the area of recreational trespass. This concept is now included with the civil liability-limiting features in a comprehensive liability and landowner control format. "Recreational trespass" means entry on land for a recreational use without the express or implied consent of the owner, or remaining on land for recreational use after being asked to leave.<sup>37</sup> The presence of a person on the land of another without an explanation for being there is *prima facie* evidence that a person is on land for a recreational purpose. Failure to post land, standing alone, is not sufficient to imply consent. However, other factors such as continuous and notorious acquiescence in public recreational use may be considered in order to imply consent.<sup>38</sup>

The burden of proof on the issue of implied consent is on the recreational user. If land is posted, consent to enter may not be implied. To constitute proper posting, signs must be conspicuously placed to afford a reasonable opportunity for a conscientious person to detect them and the warnings they convey. *Prima facie* evidence of conspicuous posting consists of proof that posters are placed at least once every 400 feet around the perimeter of land, or at least once every twenty acres of land, and that the posters are of a type that could withstand the elements for twelve months prior to the entry in question.<sup>39</sup>

In addition to recreational trespass, the 1979 Proposed Model Act defined other violations. Destruction or vandalism of any sort while engaged in recreational use, littering, and failure to leave gates, doors, fences, roadblocks, obstacles, or signs in the condition they were found in also constitute violations.<sup>40</sup> Violations of these prohibitions result in civil forfeiture of not more than \$100, plus costs and taxes, and may result in a civil action in which reasonable punitive damages may be

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36. *Id.* § 5.

37. *Id.* § 2(5).

38. *Id.* § 6.

39. *Id.*

40. *Id.* § 7.

awarded.<sup>41</sup> All or part of the civil forfeiture amount may be paid to the owner of the land as compensation for damages, attorney's fees, or inconvenience suffered due to the violations.<sup>42</sup>

Any local, county, or state law enforcement officer may enforce the 1979 Proposed Model Act by issuing a citation, enforced through a civil citation and hearing procedure. Convictions, guilty pleas, or pleas of no contest result in the revocation of current hunting, fishing, or snowmobiling licenses. Additionally, the guilty party may not reapply for such licenses for one year.<sup>43</sup>

Certain offenses are considered aggravated violations under the 1979 Proposed Model Act if they occur while the recreational trespass occurs. These include: (1) operation of a motorized vehicle in a way that endangers others; (2) intentionally or accidentally lighting a fire or performing an act inherently dangerous to persons or property; or (3) shooting a firearm or bow and arrow, or setting traps for animals.<sup>44</sup> The penalty for conviction of an aggravated violation is increased to \$300. Items of personal property may be forfeited to the citation-issuing officer to secure payment of the amount due upon conviction. If payment of the fine is not made within thirty days after final disposition, the seized property can be sold at public sale and applied to the amount due.<sup>45</sup> If a defendant is convicted of a second violation within one year of a first conviction (or plea of guilty or no contest), the maximum penalties are doubled.<sup>46</sup> If a defendant is convicted of violating the 1979 Proposed Model Act, and within three years prior to the conviction the defendant fails to pay or honor any deposit specified in a citation or to appear to contest a citation, the maximum penalties for the conviction can be multiplied by a factor of ten.<sup>47</sup>

### III. RECREATIONAL USE STATUTES IN THE COURTS

#### A. *Constitutionality Under Federal and State Rules*

Recreational use statutes, as modifiers of the general rules for determining liability, pose several constitutional questions involving equal protection, equal access to the courts, and due process of law. After enactment of these laws, several challenges have been brought by plaintiffs

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41. *Id.* § 8.

42. *Id.* § 10.

43. *Id.* § 14.

44. *Id.* § 12.

45. *Id.* § 14.

46. *Id.* § 16.

47. *Id.* § 17.

who feared the liability-limiting feature would be an insurmountable roadblock to recovery for personal injuries. In all such cases, courts upheld the statute against these challenges. However, in North Carolina the legislature repealed its recreational use statute on the basis of unconstitutionality.<sup>48</sup>

1. *Equal Protection.*—Statutes that limit a property owner's liability for injuries sustained on his or her property are not special laws in contravention of the state constitution, and do not deny equal protection.<sup>49</sup> If the statute does not affect a suspect class or a fundamental right, its classification need only be rationally related to some legitimate government purpose in order to withstand an equal protection challenge.<sup>50</sup> Users of another's property have always been considered a distinct class, with their rights distinguishable from the rights of other users. Opening up vast areas of vacant but private lands to the general public's use for recreational purposes is a legitimate state objective, and the statutory limitation of liability is rationally related to that purpose.<sup>51</sup>

2. *Denial of Access to the Courts and Due Process of Law.*—A number of state constitutions provide that “[a]ll courts are to be open, and every person, for an injury done to him in his person, property or reputation, shall have remedy by due course of law . . .”<sup>52</sup> Statutory schemes, such as recreational use statutes, do not restrict the right to redress for an actionable injury; rather, they redefine the injury or the class of persons to which the constitutional right of redress attaches. Thus, the right of redress for injury is constitutional in nature, but the nature of a specific injury is a right derived from the common law or statute.<sup>53</sup> A statute limiting the liability of owners who provide the public with park area for outdoor recreational purposes is a reasonable exercise of legislative power, and does not violate the constitutional requirement that courts be open to every person for redress of any injury.<sup>54</sup>

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48. B. VAN DER SMISSSEN, RECREATIONAL USER STATUTES 1 (1987) (referring to N.C. GEN. STAT. § 113-120.5 to .7, *repealed* by Sessions Laws 1980, C. 830, S. 1).

49. *Goodson v. City of Racine*, 61 Wis. 2d 554, 213 N.W.2d 16, 20, (1973). Plaintiff challenged a recreational use statute on grounds that it violated art. IV, § 32 of the Wisconsin Constitution, which requires: “The legislature shall provide general laws for the transaction of any business that may be prohibited by section thirty-one of this article, and all such laws shall be uniform in their operation throughout the state.”

50. *Ryszkiewicz v. City of New Britian*, 193 Conn. 589, 479 A.2d 793, 798 (1984).

51. *Genco v. Connecticut Light & Power Co.*, 7 Conn. App. 164, 508 A.2d 58, 63 (1986).

52. *See, e.g.*, CONN. CONST. art. I, § 10.

53. *Genco*, 508 A.2d at 63.

54. *Abdin v. Fischer*, 374 So. 2d 1379, 1381 (Fla. 1979), *rev'd sub nom. Sea Fresh Frozen Products, Inc. v. Abdin*, 411 So. 2d 218 (Fla. Dist. Ct. App. 1982), *petition denied*, 419 So. 2d 1195 (Fla., 1982).

### *B. How Should the Act be Interpreted?*

Courts are split on how recreational use statutes should be interpreted. Some courts hold that recreational use statutes do not alter the common-law duty toward adult trespassers, but do reduce the owner or occupier's duty to licensees. In these cases, the statute is in derogation of the common-law determination of duty, and therefore its provisions must be strictly construed.<sup>55</sup>

Other courts describe such statutes as merely codifications of the common-law duty owed by owners and occupiers of land to licensees, and therefore they are to be construed liberally in order to give them validity and to fulfill their purpose.<sup>56</sup> The question of interpretation is central to evaluating the concept's significance because extension of the statute's protection arguably would benefit landowners at the expense of land users. Because both model acts still impose liability in cases of willful or malicious failure to guard or warn against a dangerous condition, liability in such cases is comparable to the common-law duty of a landowner or occupier to warn those entering the land of dangerous conditions on the land. This analysis, however, overlooks the requirement that the failure to guard or warn must be willful or malicious, rather than merely a negligent oversight or omission. Resolving this question is uniquely a matter of local law and a question of the extent of liability protection legislatures are willing to extend. The lack of a consensus, however, creates the potential for different results from one jurisdiction to another, and creates confusion among those whom the act is intended to benefit.

### *C. Who is Protected by a Recreational Use Statute?*

Under the 1965 Model Act, a possessor of a fee interest in property or a lesser interest, such as a tenant, lessee, occupant, or a person in control of the premises can claim the Act's protection.<sup>57</sup> The 1979 Proposed Model Act, however, protects *any* individual, legal entity, or

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55. *O'Connell v. Forest Hill Field Club*, 119 N.J. Super. 317, 320-21, 291 A.2d 386, 388 (1972). The court refused to apply the New Jersey Landowner Liability Act, N.J. STAT. ANN. § 2A-42A-2, to a situation in which a three-year-old infant, who was known to have previously trespassed onto the defendant's golf course, fell into an excavation and was injured. In the court's view, this set of facts was not the type of "sport and recreational activity" to which the Act would apply. *O'Connell*, 119 N.J. Super at 322, 291 A.2d at 389.

56. *Thomason v. Olive Branch Masonic Temple*, 156 Mich. App. 736, 401 N.W.2d 911, 912 (1986). The court concluded that the Michigan recreational use statute, MICH. COMP. LAWS § 300.201, applied to a one-acre unimproved parcel of land in an urban area. MICH. COMP. LAWS ANN. § 300.201 (West Supp. 1990).

57. 1965 MODEL ACT, *supra* note 13, § 2(a).

governmental agency having any ownership or security interest or having a lease or right of possession in land.<sup>58</sup> Among the decisions focusing on the eligibility of an interest holder, protection has been extended to easement holders,<sup>59</sup> contractors whose possession is related only to completion of a repair contract,<sup>60</sup> and those whose status can be classified as lessee rather than licensee.<sup>61</sup> Regarding the 1979 Proposed Model Act, the decision to extend protection to holders of security interests is intriguing. This group has not faced a significant threat of exposure to liability in cases of recreational use. If the group is not being significantly threatened, why should protection be extended?

A more widely litigated issue on the question of who is entitled to the Act's protection is how the Act treats federal, state, or local governmental entities. The federal government owns significant acreage in recreational use. The Federal Tort Claims Act<sup>62</sup> makes the United States liable for the negligence of its agents and employees in the same manner and to the same extent as a private individual would be in similar circumstances. If a jurisdiction protects landowners who offer their land for recreational use, the United States, as a landowner conducting the same activity as private landowners, should have the same protection.<sup>63</sup> In states such as Illinois that extend recreational use statute protection only to landowners who hold their land out to the public for recreational use on an infrequent basis, the government would be subject to the same rules.<sup>64</sup>

When a state or local government is the owner, occupier, or entity in control of premises on which injury occurred, the application issue has had mixed results. In some cases, the court interpreted "owner" to include state or local governmental entity, thereby extending the protection to such entity.<sup>65</sup> In many cases, however, the question of extending recreational use protection to government entities also involves a question of whether sovereign immunity applies to the agency. In recent years, sovereign immunity has received considerable attention, resulting in widespread revision of the concept and its application.

In *Hovert v. City of Bagley*,<sup>66</sup> the Minnesota Supreme Court held that the purpose and title of the Minnesota recreational use statute<sup>67</sup>

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58. 1979 PROPOSED MODEL ACT, *supra* note 28, § 2(2).

59. *Estate of Thomas v. Consumers Power Co.*, 58 Mich. App. 486, 228 N.W.2d. 786, *aff'd in part, rev'd in part*, 394 Mich. 459, 231 N.W.2d 653 (1975).

60. *Denton v. L.W. Vail Co.*, 23 Or. App. 28, 541 P.2d 511, 515 (1975).

61. *O'Shea v. Claude C. Wood Co.*, 97 Cal. App. 3d 903, 159 Cal. Rptr. 125, 128-29 (1979).

62. 28 U.S.C.A. § 2674 (West 1965).

63. *Simpson v. United States*, 652 F.2d. 831, 833 (9th Cir. 1981).

64. *Miller v. United States*, 442 F. Supp. 555, 561 (N.D. Ill. 1976).

65. *Bailey v. City of North Platte*, 218 Neb. 810, 359 N.W.2d 766, 767 (1984).

66. 325 N.W.2d 813 (Minn. 1982).

67. MINN. STAT. ANN. §§ 87.01-.03 (West Supp. 1990).

plainly refer to public use of private land; therefore, the legislature did not intend to have public land included in the recreational use statute.<sup>68</sup> Because the legislature passed the recreational use statute after adopting new sovereign immunity rules, the legislature easily could have included state government within the recreational use statute if it had intended to do so.<sup>69</sup> In *Pennsylvania v. Auresto*,<sup>70</sup> the Pennsylvania Supreme Court reasoned that when the Pennsylvania legislature restored limited sovereign immunity, immunity was waived as a bar to actions against the Commonwealth for damages that would be recoverable if the injury was caused by a person not having the defense of sovereign immunity.<sup>71</sup> When the recreational use statute was passed, the legislature intended the Commonwealth's exposure to suit to be the same as a private citizen's exposure. If private citizens could seek the protection of the recreational use statute, so could the Commonwealth.<sup>72</sup>

In contrast, in *Pensacola v. Stam*<sup>73</sup> the court held that the purpose of the Florida recreational use statute<sup>74</sup> was to encourage private citizens and entities to make their land available for public recreation.<sup>75</sup> A governmental body needs no such motivation. Its principal purpose for owning public park land is to make the park available for public use. Therefore, the recreational use statute should not be interpreted to extend its protection to governmental entities that are already charged with making their land available to the public. If a statutory interpretation does not further a statutory purpose, the interpretation has no basis and cannot be sustained.

#### *D. To What Type of Property Does the Act Apply — Land in Rural Areas, Urban Areas, or Both?*

The 1965 Model Act includes land, roads, waters, watercourses, private ways and buildings, structures, and machinery or equipment when attached to the realty in the definition of land.<sup>76</sup> From these rather general guidelines, courts have added an additional qualification that looks to the location of the land as a determinant of coverage. Should

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67. MINN. STAT. ANN. §§ 87.01-.03 (West Supp. 1990).

68. *Hovert*, 325 N.W.2d at 815.

69. *Id.* at 816.

70. 511 Pa. 73, 78, 511 A.2d 815, 817 (1986).

71. *Id.*

72. *Id.*

73. 448 So. 2d 39, 41 (Fla. Dist. Ct. App. 1984).

74. FLA. STAT. ANN. § 375.251 (West 1988).

75. *Pensacola*, 448 So. 2d. at 41.

76. 1965 MODEL ACT, *supra* note 13, § 2; *see also* 1979 PROPOSED MODEL ACT, *supra* note 28, § 2(1).

the Act extend its protection to all landowners, or only to a select group? Courts have used a variety of approaches to resolve the issue.

Interpreting New Jersey's recreational use statute,<sup>77</sup> the New Jersey Supreme Court in *Harrison v. Middlesex Water Company*<sup>78</sup> held that the Act does not grant immunity to owners or occupiers of land located in residential and populated neighborhoods.<sup>79</sup> Under the New Jersey Act, an owner of land is granted protection whether or not the land is posted under New Jersey law.<sup>80</sup> The reference to the posting statute is a strong indication, in the supreme court's opinion, that the legislature intended the recreational use statute to apply to underdeveloped, open and expansive rural and semi-rural properties where hunting, fishing, trapping, and other recreational activities might be expected to occur.

In determining whether a tract of land is within the purview of the Act, the tract's size and location are relevant factors. Would it be reasonable to expect a landowner, without extraordinary effort, to maintain supervision over the property in question such that those who enter for recreational purposes would be noticed?<sup>81</sup> If it is unreasonable or impractical to expect the landowner to maintain such supervision, the recreational use statute can be interpreted to apply to such tracts.<sup>82</sup> In *Ratcliff v. Town of Mandeville*,<sup>83</sup> the Louisiana Supreme Court followed precedent and held that the Louisiana recreational use statute<sup>84</sup> applied to land that is underdeveloped, nonresidential, and rural or semi-rural.<sup>85</sup>

In *Wymer v. Holmes*,<sup>86</sup> the Michigan Supreme Court held that the legislature intended that Michigan's use statute<sup>87</sup> apply to specifically enumerated outdoor activities that generally require large tracts of open, vacant land in a relatively natural state.<sup>88</sup> It was not intended to cover urban, suburban, and subdivided lands.<sup>89</sup> In *Paige v. North Oaks Partners*,<sup>90</sup> the court found nothing in the statute or its legislative history

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77. New Jersey Landowner's Liability Act, N.J. STAT. ANN. § 2A:42A-2 (West 1987).

78. 80 N.J. 391, 403 A.2d 910 (1979).

79. *Id.*

80. N.J. STAT. ANN. § 23:7-1 to -8 (West Supp. 1990).

81. *Scheck v. Houdaille Constr. Materials, Inc.*, 121 N.J. Super. 335, 342, 297 A.2d 17, 21 (N.J. Super Ct. Law Div. 1972).

82. *Wymer v. Holmes*, 429 Mich. 66, 412 N.W.2d 213, 219 (1987); *Krevics v. Ayars*, 141 N.J. Super. 511, 358 A.2d 844, 846 (Salem County Ct. 1976).

83. 502 So. 2d 566, 567 (La. 1987).

84. LA. REV. STAT. ANN. § 9:2795 (West Supp. 1990).

85. *Ratliff*, 502 So. 2d at 567.

86. 429 Mich. 66, 412 N.W.2d 213 (1987).

87. MICH. COMP. LAWS § 300.201 (1984).

88. *Wymer*, 412 N.W.2d at 219.

89. *Id.*

90. 134 Cal. App. 3d 860, 184 Cal. Rptr. 867, 869 (1982). This case involved a

that evidenced a legislative intent to relieve all landowners of liability for injury to trespassing children whose activities are considered recreational.<sup>91</sup> Although the statute can be interpreted literally to apply to a given situation, this interpretation should not prevail over the actual purpose of the legislation.

#### *E. What Activities are Considered Recreational?*

Each of the model acts defines differently those recreational activities that bring the act into play. The 1965 Model Act specifies activities such as hunting, fishing, swimming, boating, and camping.<sup>92</sup> The 1979 Proposed Model Act resolves the problem of how to treat activities that do not appear on the list by using general terms such as "any activity undertaken for exercise, education, relaxation or pleasure."<sup>93</sup> In addition, a number of states have added their own specific activities.<sup>94</sup>

Several courts have considered whether specific activities are considered "recreational" for purposes of the Act. *Villanova v. American Federation of Musicians*<sup>95</sup> observed that activities described in the New Jersey recreational use statute are more often than not physical, are typically performed outdoors, and are not generally considered spectator sports.<sup>96</sup> Applying this standard, the court denied coverage to a band member injured while approaching a bandstand.<sup>97</sup> *Fisher v. United States*<sup>98</sup> added that if the general public reasonably regards the activity as recreational, the recreational use statute should also consider it as such.<sup>99</sup> Accordingly, the court concluded that a child injured at a picnic on a school field trip was engaged in a "recreational activity" when the injury occurred.<sup>100</sup> The court in *Smith v. Scrap Disposal Corporation*<sup>101</sup> con-

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minor who was injured while jumping over an open trench at a temporary construction project near the loading dock of a supermarket, in an urban shopping center. The landowner defended by asserting that the California recreational use statute immunized the landowner. *See CAL. DIV. CODE § 846* (West Supp. 1990).

91. *Paige*, 184 Cal. Rptr. at 869.

92. 1965 MODEL ACT, *supra* note 13, § 2. Other acts that are considered recreational are picnicking, hiking, pleasure driving, nature study, water skiing, winter sports, and viewing or enjoying historical, archeological, scenic, or scientific sites.

93. 1979 PROPOSED MODEL ACT, *supra* note 28, § 2(3).

94. *See, e.g.*, MD. NAT. RES. CODE ANN. §§ 5-1101(c) and 5-1102(a) (1984), which added "educational activities" to the list found in the 1965 MODEL ACT.

95. 123 N.J. Super. 57, 59, 301 A.2d 467, 469 (1973).

96. *Id.*

97. *Id.*

98. 534 F. Supp. 514, 516 (D.C. Mont. 1982).

99. *Id.*

100. *Id.*

101. 96 Cal. App. 3d 525, 158 Cal. Rptr. 134 (1979).

sidered whether the injured person entered the property with the intent to engage in a recreational activity or some other pursuit.<sup>102</sup>

Deciding that recreational activities conducted in rural areas should be covered, and those conducted in residential or urban areas should not, *Boileau v. DeCecco*<sup>103</sup> held that although swimming is a recreational activity covered by the Act, the Act was intended to apply only to those conducted in the true outdoors, rather than in a person's backyard.<sup>104</sup> The question of literal interpretation of the listed activities is closely tied to the question of how the Act is to be interpreted. *Gerkin v. Santa Clara Valley Water District*<sup>105</sup> considered whether walking a bicycle across a wooden bridge could be viewed as hiking for purposes of the statute. In concluding it did not, the court noted that although hiking included walking, this literal interpretation of activities considered to be recreational should not prevail over the plain purpose of the statute.<sup>106</sup> In addressing the question of how to interpret "other recreational pursuits," the court in *Hager v. Griesse*<sup>107</sup> held that a poolside wrestling match that resulted in one participant being thrown into a swimming pool would be included in the phrase.<sup>108</sup>

Two cases that extended protection of the Act involved injuries that occurred on a beach. *Schneider v. United States*,<sup>109</sup> interpreting the Maine recreational use statute objectively rather than subjectively, held that an injury that occurred while proceeding to a beach to drink coffee stemmed from a recreational activity.<sup>110</sup> *Fetherolf v. Ohio Department of Natural Resources*<sup>111</sup> held that sitting on a beach watching others swim was a recreational activity covered by the Act, even though the injured person did not swim.

The fact that injury occurs at a place where recreational activities normally occur is not determinative of whether the Act applies. In *Smith v. Southern Pacific Transportation Company*,<sup>112</sup> the court held that simply because an accident occurred as a truck drove through a city park on travel not associated with recreation was not enough to invoke the Act's protection. In *Harrison v. Middlesex Water Co.*,<sup>113</sup> the court held that

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102. 158 Cal. Rptr. at 137.

103. 125 N.J. Super. 263, 310 A.2d 497 (1973).

104. *Id.* at 267, 310 A.2d at 499-500.

105. 95 Cal. App. 3d 1022, 157 Cal. Rptr. 612 (1979).

106. *Gerkin*, 157 Cal. Rptr. at 615-16.

107. 29 Ohio App. 3d 339, 505 N.E.2d 982 (1985).

108. 505 N.E.2d at 986.

109. 760 F.2d 366 (1st Cir. 1985).

110. *Id.* at 368.

111. 7 Ohio App. 3d 110, 454 N.E.2d 564, 566 (1982).

112. 467 So. 2d 70, 73 (La. 1985).

113. 80 N.J. 391, 402, 403 A.2d 910, 915 (1979).

an individual injured while attempting to rescue two children who had fallen into a frozen pond was not engaged in recreation when the injury occurred.

#### *F. Exceptions to the Act's Protective Provisions — Imposing a Charge for Use of the Premises*

When the 1965 Model Act was developed, it was clearly intended to encourage landowners to make their land available for recreational use without a charge or cost being imposed on the user. The Act specifically stated that nothing in it would limit liability for injury suffered when the landowner imposed a charge on the person who entered the land.<sup>114</sup> "Charge" is defined broadly as an admission price or fee asked in return for an invitation or permission to go on the land of another.<sup>115</sup> If a charge is imposed, the recreational use statute does not apply, and the landowner owes the requisite duty to those who paid a fee to use the land.

The 1979 Proposed Model Act focused on the question of a landowner's ability to impose a charge and still gain protection from the Act. A frequent complaint about the 1965 Model Act was its sweeping definition that could include many types of exchanges, such as sharing fish or game, or holiday gifts. Landowners also argued that stubborn adherence to the prohibition against charging a fee imposed a severe disadvantage upon them because they could not even recover the costs incurred in making the land available for recreation without losing the protection of the Act.<sup>116</sup> If this situation was allowed to continue, landowners would find that the cost of providing access outweighs the benefits, and would then choose to deny access. Landowners could cut costs and minimize liability exposure simply by eliminating access that could lead to injury.

The 1979 Proposed Model Act addressed this problem by redefining "charge." The term would still include an admission fee for entry, but it would specifically exclude such items as sharing fish and game, contributions in kind, services or cash paid for the sound conservation of the land, and sums paid by private individuals or associations when the annual aggregate of such sums did not exceed a limit set by an adopting state.<sup>117</sup> Several states also recognized the landowners' dilemma, and

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114. 1965 MODEL ACT, *supra* note 13, § 6(a).

115. *Id.* § 2(d).

116. Owen, *Recreational Use on Industrial Forest Ownership Problems and Opportunities*, Proceedings of the Conference on Income Opportunities for the Private Landowner Through Management of Natural Resources and Recreational Access (WVA Univ. Coop. Ext. Ser. 362-64 (1990)) [hereinafter "Recreational Use Conference"].

117. 1979 PROPOSED MODEL ACT, *supra* note 28, § 5(2).

modified their recreational use statutes to allow a landowner some flexibility in accepting funds to offset costs and expenses of making the land available.<sup>118</sup>

In states having a generally defined "charge," several decisions provide important definition to the purpose it serves. The policy underlying the "consideration" exception is to retain tort liability when use is granted in return for an economic benefit. In these situations, the potential for profit is considered sufficient to encourage owners who want to make commercial use of their land to open it to the public. The further stimulus of tort immunity is unnecessary.<sup>119</sup> Such landowners can purchase liability insurance and spread the cost of accidents among all users of the land.

Several cases have examined the issue of direct versus indirect fee payment. In *Kisner v. Trenton*,<sup>120</sup> the court held that by allowing people to swim for free, a marina operator encouraged prospective customers to come to the site and thereby increased the marina's sales. The court concluded that a charge was imposed on the user. Receipt of a portion of the gross receipts from the concessions, although indirectly received by the landowner, was sufficient to conclude that the landowner received consideration in return for the use of the recreational facility.<sup>121</sup> Under the Mississippi recreational use statute,<sup>122</sup> operation of a concession stand by a landowner on the recreational area will prevent the application of

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118. *E.g.*, ARK. STAT. ANN. tit. 18, ch. 11, § 302(4) (1987) provides that contributions in kind, services, or cash paid to reduce and/or offset costs and eliminate losses from recreational use are excluded from the definition of "charge." Sharing of game, fish, or other products of recreational use are also excluded. *Id.*

TEX. CIV. PRAC. & REM. CODE ANN. § 75.003(c)(2) (Vernon Supp. 1990) provides that owners, lessees, and occupiers whose total charges for entry to the premises collected in the previous calendar year for all recreational use exceed twice the amount of the *ad valorem* taxes imposed on the premises are excluded from the Texas Limitation of Landowner Liability Act.

WIS. STAT. ANN. § 895.52(6)(a) (West Supp. 1990) provides that the recreational use statute does not apply to owners who collect money, goods, or services in payment for the use of their land in an aggregate amount of more than \$2000 in the year in which the injury occurs. The following items are not considered payment to a private property owner: Gifts of wild animals or other products of the recreational activity; indirect nonpecuniary benefits; donation of money, goods, or services for management and conservation of resources on the property; payment of not more than \$5 per person per day for permission to gather any product of nature on an owner's property; payments received from governmental bodies; and payments received from a nonprofit organization for a recreational agreement. *Id.*

119. *Ducey v. United States*, 713 F.2d 504, 510-11 (9th Cir. 1983).

120. 158 W. Va. 997, 216 S.E.2d 880, 885-86 (1975).

121. *Ducey*, 713 F.2d at 513-14.

122. MISS. CODE ANN. § 89-2-7 (Supp. 1990).

the statute to injuries suffered by recreational users.<sup>123</sup> In *Jones v. United States*,<sup>124</sup> the court held that payment of a \$1.00 rental fee to a concessionaire for an inner tube used at a snow play area was not a charge for the use of the land such that the owner would lose the immunity of the recreational use statute.

At least two courts have considered whether fees paid to park vehicles at a recreational site constitute consideration. In *Hogue v. Stone Mountain Memorial Association*,<sup>125</sup> a fee paid to enter and re-enter a recreational area was deemed a motor vehicle fee and not a fee for recreational use of the park.<sup>126</sup> In *Huth v. Ohio Department of Natural Resources*,<sup>127</sup> the court held that the fee paid to park a camping trailer at a state park was a charge necessary to utilize the overall benefits of the recreational area and would be considered a charge, thereby resulting in loss of the recreational use statute's protection.<sup>128</sup>

*Livingston v. Pennsylvania Power & Light Co.*<sup>129</sup> considered whether a one-time easement fee imposed on lot owners by the developer of a recreational lake to provide the lot owners with access to the lake for recreational activities was a charge. Interpreting "charge" according to its common and approved usage, the court concluded that the term signified a quid pro quo, a charge in exchange for permission to enter the land at that time.<sup>130</sup> Payment of the easement fee in *Livingston* was a one-time charge imposed on abutting land owners and was remote in time from the incident that injured the plaintiff. Therefore, the court concluded that payment of the easement fee could not be considered a "charge" under the Act.<sup>131</sup>

*Zackhery v. Crystal Cave Co., Inc.*<sup>132</sup> also interpreted the meaning of "charge" under a recreational use statute. In *Zackhery*, the court faced the question of whether the landowner's imposition of a fee to enter a cave prevented application of the recreational use statute when the injury occurred at a place where no fee was imposed to use the

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123. *Jones v. United States*, 693 F.2d 1299, 1303 (9th Cir. 1982).

124. *Id.*

125. 183 Ga. App. 378, 358 S.E.2d 852 (1987).

126. 358 S.E.2d at 854.

127. 64 Ohio St. 2d 143, 413 N.E.2d 1201 (1980).

128. 413 N.E.2d at 1203.

129. 609 F. Supp. 643 (E.D. Pa. 1985).

130. *Id.* at 648.

131. *Id.*

132. 391 Pa. Super. 471, 571 A.2d 464 (1990). In this case, the plaintiff was injured when he fell from a sliding board at a 125-acre recreational area that included a playground, parking lot, several buildings, and an underground cave. The landowner imposed a charge to enter the cave, but not to park or to use the playground where the sliding board was located.

facility. The court noted that the recreational use statute does not even hint that the immunity offered by the Act to an entire parcel of land is nullified if a landowner charges admission to a different portion of the parcel.<sup>133</sup> The court held that imposing a fee to enter the underground cave did not prevent application of the recreational use statute if the injury occurs on a portion of the property where no fee is charged.<sup>134</sup>

Although this conclusion will find favor among landowners who eagerly greet the expansion of protection, the decision leaves some unsettled questions. For instance, is the payment of a fee the only way to lose protection, or will it also be lost if a person enters intending to pay for recreation and is injured before actually doing so? Similarly, how can the limits of the fee-based recreational area be distinguished from the free access areas? The recreational area in *Zackhery* is a comprehensive, integrated, and coordinated recreational complex where the playground is an essential accessory to the fee-paid underground cave. Having the no-cost facilities available to patrons makes this recreational area more attractive, especially to families with young children. By offering free activities, attendance at the fee-paid activity would be expected to rise. *Zackhery* did not address these questions, but they likely will be raised in the future.

#### *G. Requirements of Landowners Seeking Protection from Recreational Use Statutes*

The 1965 and 1979 Model Acts offer sweeping protections. An owner of land owes no duty to keep the premises safe for entry or use by others for recreational purposes, or to give any warning of a dangerous condition, use, structure, or activity to persons entering for recreational purposes.<sup>135</sup> A landowner who directly or indirectly invites or permits any person to use his or her land without charge does not assure that the premises are safe for any purpose. Nor does the landowner confer the status of invitee or licensee on the user, or assume responsibility for, or incur liability for, any injury caused by an act or omission of such users.<sup>136</sup>

Comparing sections 3 and 4, the most obvious difference is the reference to an invitation to the public to use the private land of the owner. If only one section of the law requires an invitation, can the

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133. *Id.* at 475, 571 A.2d at 466.

134. *Id.*

135. 1965 MODEL ACT, *supra* note 13, § 3; 1979 PROPOSED MODEL ACT, *supra* note 28, § 3.

136. 1965 MODEL ACT, *supra* note 13, § 4. 1979 PROPOSED MODEL ACT, *supra* note 28, § 4.

other section be applied when no proof of invitation is found? Recognizing this potential dilemma, several states have modified their statutes to require some form of invitation for the act to apply.<sup>137</sup>

In those states having adopted the Model Act without modification, the significance of an owner's willingness to accept those who want to use the land for recreation has been a frequently litigated issue. If the Act's purpose is to encourage landowners to make their land available for public recreation, must there be some evidence of compliance with this purpose for the Act to apply? If there is no evidence, or if the evidence suggests that the landowner is not willing to accept recreational users, what effect does this have on applying the benefits of the Act?

In *Gibson v. Keith*,<sup>138</sup> the court held that a landowner's invitation or permission is a *sine qua non* for invoking the Delaware statute's benefits.<sup>139</sup> Lacking evidence that the landowner offered the land for public use, there is no evidence of either a direct or indirect invitation, and therefore the protective provisions of the Act do not apply.<sup>140</sup>

When evidence shows an active effort to exclude the public from use of the premises or to significantly limit public access, courts have reached mixed conclusions. Must a landowner post the land to inform the public of a willingness or unwillingness to make the land available? Has the landowner who posts "no trespassing" signs declined the opportunity to claim protection of the Act, or is it still available? If the "no trespassing" sign is interpreted as the landowner's unwillingness to consent to entry, the invitation element would be missing.<sup>141</sup> On the other hand, a landowner can post the property with signs of many different types, each conveying a distinct message. For example, would a "no hunting or fishing" sign imply that other uses are permitted? Would a sign stating, "Enter at your own risk" be treated as an invitation or as a denial of an invitation?

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137. See, e.g., Miss. CODE ANN. § 89-2-7 (Supp. 1990), which requires a landowner to annually publish public notice of the availability of the land for public recreation in order for the Mississippi Act to apply. R.I. GEN. LAWS § 32-6-7 (1982) requires owners who desire to make their property available under the Act to first offer permission to the public to be set forth in a letter to the Director of the Department of Environmental Management. ALA. CODE § 35-15-28 (Supp. 1990) creates a rebuttable presumption of having opened land for noncommercial public recreation when the land is posted for that purpose, or when a notice is published in a newspaper of general circulation or recorded in the public records of the county in which the land is located.

138. 492 A.2d 241 (Del. Super. Ct. 1985).

139. *Id.* at 244.

140. See, e.g., *Hughes v. Quarve & Andersen Co.* 338 N.W.2d 422, 427 (Minn. 1983); *Watters v. Buckbee Mears Co.*, 354 N.W.2d 848, 852 (Minn. Ct. App. 1984).

141. See, e.g., *Georgia Power Co. v. McGruder*, 229 Ga. 811, 194 S.E.2d 440, 441 (1972), which held that when land was posted with "keep out" signs, use of the land was expressly denied, and therefore the Georgia recreational use statute did not apply.

Two cases attempted to resolve the questions posed by these sections. In *Johnson v. Stryker Corporation*,<sup>142</sup> the court, focusing on the provisions of sections 3 and 4 of the Illinois act that follows the 1965 Model Act, held the recreational use statute was not intended to apply only when land is open to public use. If section 3, which does not require an invitation, is not to be rendered superfluous, it must apply when no permission, either express or implied, is required.<sup>143</sup> If land is open to the general public, the public is directly or indirectly invited. Therefore, if the Act applies only to land open to the general public, section 3 appears to be superfluous.<sup>144</sup>

The second case attempting to reconcile these questions is *Friedman v. Grand Central Sanitation, Inc.*<sup>145</sup> Interpreting the Pennsylvania recreational use statute,<sup>146</sup> the court noted that the 1966 statute replaced a statute that offered broad immunity to agricultural land and woodland owners who made their land available for hunting and fishing, except for injuries suffered as a result of the landowner's willful or deliberate acts.<sup>147</sup> The court noted that the legislature apparently felt it necessary to replace the earlier statute with another broad immunity-granting provision such as that found in section 3 of the recreational use statute, even though the immunity granted in section 3 was not in direct fur-

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142. 70 Ill. App. 3d 717, 388 N.E.2d 932, 935 (1979). In this case, the plaintiff sued a landowner for injuries suffered while swimming in a pond. The landowner defended the claim by asserting the Illinois recreational use statute, ILL. STAT. ch. 70, para. 31. The plaintiff responded by arguing that the Act did not apply because the property was not open to the public. The evidence showed that although some students used the farm pond, they were supposed to ask permission first, and usually did. In addition, the landowner had posted several signs, including one that stated, "private property — no swimming on holidays." *Johnson*, 388 N.E.2d at 935.

143. *Johnson*, 388 N.E.2d at 935.

144. *Id.*

145. 524 Pa. 270, 571 A.2d 373 (1990). *Friedman* dealt with a person who was injured when he fell into a ditch on property maintained as a sanitary landfill. The person had been hunting on adjoining property and mistakenly wandered onto the landfill property. The landfill owner had clearly taken steps to exclude recreational users from the landfill areas and understandably so. In furtherance of this goal, the landfill posted "no trespassing" signs, patrolled the property, and prosecuted trespassers. Clearly this was not a situation in which the landowner offered its property for public recreation. The landfill owner defended the personal injury claim on several grounds, including the Pennsylvania recreational use statute (PA. STAT. ANN. tit. 68, § 477-1) (Purdon Supp. 1990)). In response, the plaintiff raised the conflict between the statutory purpose of the recreational use statute and the grant of immunity found in the Act. *Friedman*, 524 Pa. at 275, 571 A.2d at 375. Can the Act be applied in a way that does not further the statutory purpose, or can the Act be applied in a case such as this in which the landowner was not encouraged to make its land available to the public by the liability protection the Act offers?

146. PA. STAT. ANN. tit. 68, § 477-1 (Purdon Supp. 1990).

147. Act of Sept. 27, 1961, Pub. L. No. 1696.

therance of the purpose of the Act.<sup>148</sup> Because the legislature intended this broad immunity to apply, the provisions of section 3 can be reconciled with section 4, which requires an invitation. When the statute is clear, such as when no invitation is required under section 3, no principle of statutory construction prevents application of the clear language of section 3 in order to pursue the spirit of the statute.<sup>149</sup>

Given the court's specific reference to the prior statute and the role it played in shaping the interpretation of section 3 of the recreational use statute, it is difficult to determine whether this decision will have a significant impact. Although the 1966 statute may directly follow the 1965 Model Act, the reference to the prior statute may not be as important as the court seems to think. However, although sections 3 and 4 were enacted as provided in the 1965 Model Act, the presence of the prior statute may have influenced the legislature when it considered adoption of the Act.

#### *H. Residual Liability Not Protected by Recreational Use Statutes*

The immunity-granting provisions of the 1965 and 1979 Model Acts are each subject to general provisos that differently approach the task of establishing a degree of continuing responsibility for acts and the liability they create. The 1965 Model Act creates the standard of willful or malicious failure to guard or warn against a dangerous use, condition, structure, or activity as the bottom-line limit of responsibility from which a landowner is not immunized.<sup>150</sup> The 1979 Proposed Model Act, however, sets the bottom-line limit at malicious, not mere negligent, failure to guard or warn against an ultrahazardous condition, structure, personal property, or activity actually known by the owner to be dangerous.<sup>151</sup> In addition to the proposed statutes, many states have enacted other features and have applied them to their individual situations.<sup>152</sup>

With any of these provisions, the key consideration is the meaning of the operative words and the circumstances under which the meaning is applied. For a willful injury to exist, there must be design, purpose, and intent to inflict the injury.<sup>153</sup> Three essential elements must be found:

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148. *Friedman*, 524 Pa. at 276-77, 571 A.2d at 375-76.

149. *Id.* at 276, 571 A.2d at 376. *See also* *Gallo v. Yamaha Motor Corp., USA*, 526 A.2d 359 (Pa. Super. 1987).

150. 1965 MODEL ACT, *supra* note 13, § 6(a).

151. 1979 PROPOSED MODEL ACT, *supra* note 28, § 5.

152. MASS. GEN. LAWS ANN. ch. 21, § 17C (West 1981) adds wanton and reckless conduct by the owner. MICH. COMP. LAWS ANN. § 300.201 (1990) adds injuries caused by the gross negligence of the owner. *See also* S.C. CODE ANN. § 27-3-60 (Law. Coop. 1977).

153. *Morgan v. United States*, 709 F.2d 580, 583 (9th Cir. 1983); *Gard v. United States*, 594 F.2d 1230, 1233 (9th Cir. 1979), *cert. denied*, 414 U.S. 866.

Actual or constructive knowledge of the peril, actual or constructive knowledge that injury is probable, and conscious failure to act to avoid the peril.<sup>154</sup> On the issue of actual or constructive knowledge of the peril and the probability of injury, not all courts agree that constructive knowledge is sufficient to classify an act as willful.<sup>155</sup> However, failure to exercise due care, or conduct amounting to negligence, does not constitute willful conduct.<sup>156</sup>

For those statutes that set the bottom-line limit at acts involving gross negligence, the interpretation of that term can have several different meanings. Is it conduct that differs from ordinary negligence only in degree, but not in kind?<sup>157</sup> Is it a term that applies to a defendant who, through the exercise of reasonable care, knows or ought to know of the plaintiff's prior negligence, but who injures the plaintiff by subsequent negligence, such as that found in the tort concept of the last clear chance to avoid injury?<sup>158</sup>

Gross negligence is significantly different from willful conduct. Both concepts share the element of knowledge of a situation that poses a risk of harm to the plaintiff. However, gross negligence involves the defendant's awareness of the defendant's ability to avoid injury to the plaintiff by the exercise of ordinary care and diligence, which the defendant subsequently fails to exercise. Having baited a trap, a landowner cannot stand by idly and await a victim.<sup>159</sup>

Idaho and Ohio, two states enacting recreational use statutes, apparently have come closest to establishing absolute liability protection for eligible landowners. Unlike the Model Acts, the Ohio statute<sup>160</sup> is not subject to a bottom-line limit on a landowner's liability. In *McCord v. Ohio Division of Parks and Recreation*,<sup>161</sup> the court held the Ohio statute precludes recovery against any landowner, including the State. The Ohio statute was to be effective in 1963, approximately two years before the advent of the 1965 Model Act.

In Idaho, section 36-1604(c) of the Idaho Code<sup>162</sup> is intended to encourage landowners to make land and water areas available to the

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154. *Von Tagen v. United States*, 557 F. Supp. 256, 259 (N.D. Cal. 1983).

155. *McGruder v. Georgia Power Co.*, 126 Ga. App. 562, 191 S.E.2d 305, 307 (1972), *rev'd on other grounds*, 229 Ga. 811, 194 S.E.2d 440 (1972).

156. *Garreans v. City of Omaha*, 216 Neb. 487, 345 N.W.2d 309, 314 (1984).

157. PROSSER AND KEETON ON TORTS § 34, at 211-12 (5th ed. 1984).

158. *Taylor v. Matthews*, 40 Mich. App. 74, 82-83, 198 N.W.2d 843, 847 (1972).

159. *Lucchesi v. Kent County Road Comm'n*, 109 Mich. App. 254, 312 N.W.2d 86, 88-89, 93 (1981).

160. OHIO REV. CODE ANN. § 1533.181(a) (Baldwin 1984).

161. 54 Ohio St. 2d. 72, 375 N.E.2d 50, 52 (1978); *see also Fetherolf v. Ohio Dep't of Natural Resources*, 7 Ohio App. 3d 110, 454 N.E.2d 566, 567 (1982).

162. IDAHO CODE § 36-1604(c) (Supp. 1990).

public for recreational purposes without charge. Under the code, a landowner owes no duty of care to keep the premises safe or to give any warning of a dangerous condition, use, structure, or activity. In *Johnson v. Sunshine Mining Co., Inc.*,<sup>163</sup> the court held that the Idaho statute meets the equal protection test under the state and federal constitutions, although a strong dissent challenged the statute's failure to eliminate liability in the case of intentional misconduct as the Model Acts propose.<sup>164</sup> In *Jacobsen v. City of Rathdrum*,<sup>165</sup> the Idaho Supreme Court addressed the question that *Johnson* declined to answer. The court held that the recreational use statute did not preclude an owner's liability for willful or wanton conduct causing injury to a person using an owner's land for recreational purposes.<sup>166</sup> The court concluded that the statute was intended to insulate landowners only from liability predicated on a duty of care owed to an invitee or licensee, but not the duty owed to a trespasser.<sup>167</sup> Those who use an owner's land for recreational purposes are entitled to at least the same protection afforded to trespassers.<sup>168</sup>

#### IV. HOW EFFECTIVE IS THE PROTECTION OFFERED BY RECREATIONAL USE STATUTES?

The simple answer to this question is that the protection afforded is really quite extensive, given that grants of immunity from suit are generally out of harmony with the modern trend in tort law.<sup>169</sup> Looking more closely at the question, however, it becomes clear that the protection is somewhat mixed and uncertain because several questions remain unanswered. For example, whether governmental landowners are covered by the Act is a question particularly ripe for consideration. The 1979 Proposed Model Act addresses this question by including any governmental agency that has ownership, a security interest, a leasehold, or the right to possession of land within the meaning of "owner." This direct approach answers the question raised in *City of Pensacola v. Stam*<sup>170</sup> of how to serve the Act's purpose. In addition, the direct approach avoids the circuitous argument that centers on the legislature's intention, or lack of it, to grant immunity in those states that have wrestled with sovereign immunity.<sup>171</sup>

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163. 106 Idaho 866, 684 P.2d 268 (1984).

164. *Id.* at 871, 684 P.2d at 273 (Huntley, J., dissenting).

165. 115 Idaho 266, 269-70, 766 P.2d 736, 739-40 (1988).

166. *Id.*

167. *Id.*

168. *Id.*

169. *Rivera v. Philadelphia Theological Seminary*, 510 Pa. 1, 12, 507 A.2d 1, 7 (1986).

170. 448 So. 2d. 39, 41 (Fla. Dist. Ct. App. 1984).

171. *Hovert v. Bagley*, 325 N.W.2d 813, 815 (Minn. 1983).

The issue of the landowner's imposition of a charge on users of the land for recreational purposes bears careful consideration. Proponents of changing the statutes point out that by making the land available to those who want to use it, landowners incur expenses.<sup>172</sup> If a landowner tries to recover these expenses, most statutes following the 1965 Model Act classify this as a charge imposed in return for use of the land, thereby triggering exclusion from the Act. Several states and the 1979 Proposed Model Act have attempted a piecemeal solution to this problem by allowing landowners to recover only minimal amounts, whether in fixed amount or by reference to other items such as taxes. In many cases, this approach provides only a partial solution.

The question of consideration paid for use attempts to differentiate landowners who want to engage in a commercial activity and bear its associated risks from landowners who do not. Landowners who intend to enter commercial activities are presumed to be aware of liability concerns and of how to deal with them. Such landowners deserve no special treatment. Noncommercial activities, however, that develop more from a willingness to permit others to use the land than from a desire to engage in a commercial activity, deserve protection. Otherwise, such landowners gain no benefit from their own generosity, yet they continue to face the risks of potential liability.

The key question, however, is where to draw the line between a commercial enterprise and a landowner who is simply willing to permit use. One court referred to this question as "[a] thicket entangled with speculation as to the motives of the landowner . . .".<sup>173</sup> If the distinction turns on intention, why not make intent the central point of the inquiry? If landowners intend to carry on a commercial activity, physical signs that manifest this intent should abound, such as marketing plans, frequency of use, promotional materials, financial books and records, and tax returns. Each of these items, coupled with the landowner's direct testimony, can be evaluated to determine the owner's intent.

A third issue is whether the protection should apply to rural, urban, or both rural and urban, land. Most courts have interpreted the Act to have a decidedly rural focus. Other courts have been more liberal in analyzing which landowners are subject to the Act. Clarification would aid the statutes. Neither the 1965 Model Act nor the 1979 Proposed Model Act attempt to do so. This results in transferring of the issue to the courts for resolution. Time and the expense of litigation then forge a resolution to the question.

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172. Recreational Use Conference, *supra* note 116, at 363-64.

173. *Friedman v. Grand Central Sanitation*, 524 Pa. 270, 277, 571 A.2d 373, 376 (1990).

A fourth issue having a dramatic impact on effectiveness of recreational use statutes involves the level of residual liability from which these statutes offer no protection.<sup>174</sup> The 1965 Model Act and the 1979 Proposed Model Act have somewhat different approaches. Much time and effort has been spent litigating (1) what is a willful act, and (2) what conditions must exist for that conclusion to be made. If additional criteria such as wanton conduct or gross negligence are added, further time and effort will be spent resolving the meaning of those terms. The 1979 Proposed Model Act attempts a solution by focusing on retaining liability for a malicious, but not for merely negligent, failure to guard or warn against an ultrahazardous condition, structure, property, or activity actually known by such owners to be dangerous.<sup>175</sup> Within the proposed solution are several questions that threaten to further confuse the issue. "Malice" and "ultrahazardous" are terms with varied meanings.<sup>176</sup> Which one will be applied? Should the solution to a problem be couched in terms that may become part of the problem rather than the solution? Further focus on the requirement of actual knowledge of the dangerous character of the condition, structure, property, or activity seems at first to be protective of the landowner's interest because it is a stricter requirement. Given the strictness and the dire consequences of failing to meet it, one would expect the plaintiffs' bar to make a concerted effort to litigate this requirement at every opportunity. Should the time and expense of litigation be used to clarify a point that is crucial to the application of the statute?

A final point concerns interpretation of the statute's liability protection provisions. Both the 1965 Model Act and the 1979 Proposed Model Act provide two specific statements protecting the owner's interest. One statement declares that there is no duty owed by the landowner; the second refers to a direct or indirect invitation or grant of permission. As *Friedman*<sup>177</sup> and *Johnson*<sup>178</sup> point out, interpreting the immunity provisions in light of the stated purpose of the Act can lead to apparent conflicts. *Friedman*'s reference to the prior legislative history of Pennsylvania's immunity issue weakens the significance of the case nationally. However, *Friedman*, read in conjunction with *Johnson*, provides a common-sense interpretation of the statutes and what they provide. If these interpretations lead to results that legislatures did not intend, the solution is legislative action to limit immunity only to those situations intended.

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174. Except in Ohio.

175. 1979 PROPOSED MODEL ACT, *supra* note 28, § 5(1).

176. *Genco v. Connecticut Light & Power Co.*, 7 Conn. App. 164, 508 A.2d 58, 63 (1986).

177. *Friedman*, 524 Pa. 570, 571 A.2d 373.

178. *Johnson v. Stryker Corporation*, 70 Ill. App. 3d. 717, 388 N.E.2d 932 (1979).

This could be best accomplished by repealing the section 3 grant of immunity, and incorporating its ideas and concepts into section 4.<sup>179</sup>

In those states having made proof of invitation an express requirement to invoke the Act, the 1979 Proposed Model Act includes the phrase "whether or not the land is posted" in the immunity-granting language of section 4. Whether this simple phrase is enough to overcome those cases that deny application of the Act when the land is posted remains to be seen. Posting the land is most often associated with the owner's right to take action to expel intruders, and arises in the quasi-criminal concept of trespass. Its application and relevance to the civil liability situation is uncertain, except in cases in which the 1979 Proposed Model Act is adopted because the 1979 Proposed Model Act brought the civil liability and trespass issues together.

#### V. CONCLUSION

If change in recreational use statutes is to be made, such change should be directed at clarifying ambiguities affecting the statutes' coverage and application in particular situations. Landowners will then have a clearer understanding of what the statute offers them in return for their decision to make their land available. Decisions made on a more informed and knowledgeable basis would be better decisions overall. Such decisions will contribute to accomplishing the goals and objectives of the statute.

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179. For example, § 4 could be amended to read as follows:

Except as provided in this Act, an owner of land who directly or indirectly invites or permits any person to enter his land for recreational use, without charge, whether or not the land is posted, does not thereby:

- (1) extend any assurance that the premises are safe for any purpose;
- (2) owe a duty of care to anyone to keep his or her land safe for recreational use, or to give any general or specific warning with respect to any natural or artificial condition, structure, personal property or activity thereon;
- (3) confer upon such person the status of an invitee, or any other status requiring of the owner a duty of special or reasonable care;
- (4) assume responsibility for or incur liability for any injury to such a person or property caused by any natural or artificial condition, structure or personal property on the premises; or
- (5) assume responsibility for any damage or injury to any other person or property caused by an act or omission of such person.



# Recreational Access to Agricultural Land: Insurance Issues

MARTHA L. NOBLE\*

## I. INTRODUCTION

In the United States, a growing urban and suburban population is seeking rural recreational opportunities.<sup>1</sup> At the same time, many families involved in traditional agriculture want to diversify and increase the sources of income from their land.<sup>2</sup> Both the federal and state governments actively encourage agriculturists to enter land in conservation programs and to increase wildlife habitats on their land.<sup>3</sup> In addition,

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1. See generally Langner, *Demand for Outdoor Recreation in the United States: Implications for Private Landowners in the Eastern U.S.*, in PROCEEDINGS FROM THE CONFERENCE ON: INCOME OPPORTUNITIES FOR THE PRIVATE LANDOWNER THROUGH MANAGEMENT OF NATURAL RESOURCES AND RECREATIONAL ACCESS 186 (1990) [hereinafter PROCEEDINGS].

2. A survey of New York State Cooperative Extension county agents and regional specialists indicated that an estimated 700 farm families in the state had actually attempted to develop alternative rural enterprises. An estimated 1,700 farm families were considering starting alternative enterprises or diversifying their farms. Many alternatives involved recreational access to the land, including the addition of pick-your-own fruit and vegetable operations, petting zoos, bed and breakfast facilities, and the provision of campgrounds, ski trails, farm tours, and hay rides on farm property. N. SCHUCK, W. KNOBLAUCH, & J. GREEN, FARMING ALTERNATIVES: RESULTS OF A SURVEY OF COOPERATIVE EXTENSION FIELD STAFF REGARDING ALTERNATIVE FARMING ENTERPRISES 2-3, 18-21 (A.E. Ext. 87-12 1987). Fee or lease hunting on agricultural land is common in many southern states, particularly Alabama, Georgia, Louisiana, Mississippi, Texas and Virginia. *Mixed Uses for Grazing Land Can Yield Extra Income*, FARMLINE, Feb. 1988, at 12-13.

3. The conservation title of the Federal Food Security Act of 1985 initiated programs, including the Conservation Reserve Program, conservation compliance, sodbuster, and swampbuster, that may significantly increase wildlife habitat in the United States. Food Security Act of 1985, Pub. L. No. 99-198, 99 Stat. 1354, 1504-1518 (codified as amended at 16 U.S.C.A. §§ 3801-3847 (West Supp. 1991)). For assessments of the benefits of these programs to wildlife, see M. RIBAUDO, D. COLACICCO, L. LANGNER, S. PIPER & G. SCHABLE, NATURAL RESOURCES AND USERS BENEFIT FROM THE CONSERVATION RESERVE PROGRAM 30-35 (USDA, Agric. Econ. Rep. No. 627, 1990); Robinson & Berner, *Implementing the Conservation Title: Effects on Wildlife*, in IMPLEMENTING THE CONSERVATION TITLE OF THE FOOD SECURITY ACT OF 1985, at 296 (1990). Title XIV of the Food,

most states have adopted recreational use statutes, which limit the tort liability of landholders<sup>4</sup> who make their land available for recreation.<sup>5</sup>

A plausible outcome of these trends is increased access to private rural land for recreational and tourist activities. Studies indicate, however, that the concern of landholders about legal liability for bodily injuries to recreational users is a major barrier to recreational access on private rural land.<sup>6</sup>

Liability insurance provides a landholder with the means of shifting to an insurer the financial risk of liability arising from the use of the land by recreational users. Although insurance will not prevent a landholder from being sued, it does provide a landholder with two major benefits: (1) payment of damages to a third party for injuries that are covered by the insurance policy, up to the amount covered by the policy;<sup>7</sup> and (2) an entity, the insurer, with a duty to defend the landholder against all actions brought against the landholder on any allegation of

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Agriculture, Conservation, and Trade Act of 1990 modified existing conservation programs and provided new conservation measures. Pub. L. No. 101-624, 104 Stat. 3359, 3568-3604 (codified at 16 U.S.C.A. §§ 3801-3847 (West Supp. 1991)). Many states have also legislated incentives for rural landowners to increase wildlife habitat. For example, Indiana law provides for a one dollar (\$1) per acre general property tax assessment rate for private land classified as wildlife habitat by the state Department of Natural Resources. The landowner must enter into an agreement with the Department that establishes standards of wildlife management for the parcel of land. IND. CODE ANN. §§ 6-1.1-6.5-1 to -25 (Burns 1989). California has initiated a private lands wildlife management program. The landowner manages the land under a wildlife management plan approved by the state Department of Fish and Game. In return, the landowner is exempt from requirements to obtain most licenses or permits or to pay fees, which would otherwise be required for activities conducted under the wildlife management plan. CAL. FISH & GAME CODE §§ 3400-3409 (West 1984 & Supp. 1991).

4. The term "landholder" as used in this Article denotes any person who has control of property when harms occur to recreational entrants on the property. Tort liability for personal injuries on land is predicated on the defendant's possession and control of the land. The general rule is that a tenant, not a landlord or lessor, is liable for injuries to third parties arising from activities on leased land. *See* 2 N. HARL, AGRICULTURAL LAW § 4.01[3] (1990). For a review of situations under which landlord liability may arise, *see* 3 N. HARL, AGRICULTURAL LAW § 8.02 (1990); RESTATEMENT (SECOND) OF TORTS § 357 (1965).

5. As of 1988, 48 states had adopted some form of recreational use legislation. For a comprehensive analysis of this legislation, *see* 2 B. VAN DER SMISSSEN, LEGAL LIABILITY AND RISK MANAGEMENT FOR PUBLIC AND PRIVATE ENTITIES 189-251 (1990). *See infra* notes 58-67 and accompanying text.

6. *See, e.g.*, Kaiser & Wright, *Recreational Access to Private Land: Beyond the Liability Hurdle*, 40 J. SOIL & WATER CONSERVATION 478, 479 (1985); R. HILDEBRANDT, PUBLIC ACCESS TO PRIVATE KANSAS LANDS FOR RECREATION 6-7 (Agric. Experiment Station, Kan. St. U., Manhattan KS, Rep. of Progress No. 582, 1989).

7. *See generally* 1 W. FREEDMAN, FREEDMAN'S RICHARDS ON THE LAW OF INSURANCE §§ 1:49, 5:1, 5:10 (6th ed. 1990).

facts and circumstances potentially covered by the insurance policy, including groundless, false, or fraudulent claims.<sup>8</sup>

The adequacy of presently held liability insurance policies and the availability of additional insurance coverage are significant financial risk management questions for farmers or ranchers who allow recreational access to their property. This Article provides an analysis of these questions in light of the exposure to legal liability that arises when agricultural landholders allow recreational use of their land. Part II of the Article provides background on the tort liability of landholders for injuries to recreational users of their land. Part III discusses the adequacy of state recreational use statutes in limiting this tort liability, and concludes that most of these statutes do not provide immunity from liability if a landholder wants to earn significant income from the recreational use of the land. Even if a landholder charges no fees for access, the statutes do not provide unequivocal liability immunity for all recreational uses and circumstances.

In Part IV, this Article examines the adequacy of coverage of liability policies that a rural landholder may already carry, including a standard farm or ranch comprehensive liability policy, a homeowner's policy, or a motor vehicle liability policy. This examination reveals that for most recreational access, these policies are too narrowly tailored to cover personal injury liability risks for recreational access, particularly if a landholder receives a fee or other monetary benefit for the access. Part V provides information on insurance that a landholder may obtain to insure against injuries to recreational entrants, and discusses risk management possibilities other than insurance carried by the landholder.

The reader should note that each state has its own laws and regulations governing tort liability and defenses, recreational use immunity, insurance policy provisions, and insurance requirements for particular enterprises. This Article is not a comprehensive and exhaustive examination of each state's laws. Rather, this Article provides a general overview of the insurance issues arising when agricultural landholders allow recreational access to their land.

## II. LANDHOLDER TORT LIABILITY FOR RECREATIONAL ACCESS

In the context of recreational access, landholder tort liability can arise from three major sources of injury to recreational users: (1) conditions on the premises; (2) activities of the landholder, including the provision of recreational equipment; and (3) domestic animals, including those provided by the landholder to the entrant for recreational use.

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8. *Id.* § 5A:3.

This section examines landholder liability under premises liability doctrines and under other tort rules that are particularly relevant to landholders who provide recreational access and services.

#### *A. Conditions on the Premises*

The majority of states follow rules governing premises liability under which the duty of care owed by landholders to entrants for conditions on the land is determined by the status of the entrant as a trespasser, licensee, or invitee.<sup>9</sup> Other states, following the lead of the California Supreme Court in *Rowland v. Christian*,<sup>10</sup> have abolished rigid status distinctions and have adopted a standard of reasonable care toward entrants based on ordinary negligence principles.

1. *Majority Rule: Liability Based on Entrant's Status.*—Under traditional premises liability rules, a landholder owes the lowest duty of care to trespassers, defined as persons who enter or remain on the land without the actual or implied consent of the landholder.<sup>11</sup> The landholder is liable for intentional, willful, or wanton acts against the trespasser. Generally, the landholder has no duty to ensure that conditions on the land are safe for trespassers or to warn trespassers of dangerous conditions.<sup>12</sup>

Some jurisdictions have carved out significant exceptions to the general rule regarding trespassers. First, a landholder who has actual knowledge or who should reasonably know that trespassers frequent the property may be held to a higher standard of care, which requires that the landholder warn trespassers of dangerous artificial conditions or that the landholder refrain from dangerous activities when trespassers are on the land.<sup>13</sup> The second exception, referred to generally as the attractive nuisance doctrine, imposes liability for physical injury to child trespassers who are attracted to dangerous artificial conditions on the land.<sup>14</sup>

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9. Indiana follows the majority rule, which bases premises liability on an entrant's status. *See Gaboury v. Ireland Road Grace Brethren, Inc.*, 446 N.E.2d 1310, 1314 (Ind. 1983).

10. 69 Cal. 2d 108, 443 P.2d 561, 70 Cal. Rptr. 97 (Cal. 1968).

11. *RESTATEMENT (SECOND) OF TORTS* § 329 (1965).

12. *Id.* § 333 (1965). Under this rule, landholders who set traps for trespassers cannot escape liability. In addition, some courts have ruled that artificially created hazards on the land may give rise to liability, even if the landholder did not have a specific intent to harm trespassers. *See 1 N. HARL, AGRICULTURAL LAW* § 4.07 (1990).

13. *RESTATEMENT (SECOND) OF TORTS* §§ 334-337 (1965).

14. Under the *Restatement* formulation of the attractive nuisance doctrine, the following elements must be found before imposing liability for injuries to child trespassers: (1) the landholder knows or has reason to know of a condition which is likely to attract children; (2) the child trespassers are too young to appreciate the danger; (3) the burden

Licensees are entrants who are privileged to enter or remain on the land by the landholder's express or implied consent.<sup>15</sup> Licensees, in contrast to invitees, are not on the premises for business purposes or other purposes that primarily benefit the landholder. This category includes recreational users such as hikers, birdwatchers, and hunters, who are on the land with the landholder's permission but pay no fees or other compensation for the use of the land. Most jurisdictions include social guests as licensees, even those guests who are on the property at the express invitation of the landholder.<sup>16</sup>

Under the *Restatement*, the landholder has a duty to warn licensees of hidden dangers known to the landholder, but has no duty to inspect the premises to ensure the licensee's safety. The landholder must also refrain from intentional, willful, or malicious conduct that may result in injury to the licensee. Some jurisdictions do not require a landholder to warn licensees of hidden dangers, and thus equate the duty of care toward licensees with the duty of care toward trespassers.<sup>17</sup>

Two definitions apply to the final category of entrants, invitees. Under the generally applied common law definition, an invitee is a person expressly or impliedly invited onto the land by the landholder for a business purpose or for other benefits to the landholder.<sup>18</sup> The *Restatement* establishes an additional category of invitees, those persons invited onto the premises as a member of the public for a purpose for which the property is maintained.<sup>19</sup>

The highest duty of care is owed to invitees. Landholders must use ordinary care to ensure that the premises are in a reasonably safe condition for any uses consistent with the purposes for which an invitation is extended. This duty also requires that the landholder periodically

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of eliminating the condition and the utility of maintaining the dangerous condition are slight compared to the risk to the children; and (4) the landholder fails to exercise reasonable care in eliminating the danger or protecting children from the danger. *Id.* § 339 (1965). Only three states - Maryland, Ohio, and Vermont - have not adopted a special rule governing a landholder's liability for harms to child trespassers. 4 S. SPEISER, C. KRAUSE, & A. GANS, *THE AMERICAN LAW OF TORTS* § 14:73 (1987).

15. *RESTATEMENT (SECOND) OF TORTS* § 330 (1965).

16. See 1 N. HARL, *AGRICULTURAL LAW* § 4.06 (1990). *But see* *Burrell v. Meads*, 569 N.E.2d 637 (Ind. 1991) (court abolishes distinction between commercial visitors and social guests, and rules that both have the tort rights of invitees).

17. 1 N. HARL, *AGRICULTURAL LAW* § 4.06 (1990).

18. For a detailed discussion of the definition of business invitee, see *Fleischer v. Hebrew Orthodox Congregation*, 504 N.E.2d 320, 322-23 (Ind. Ct. App. 1987), *cited with approval in Burrell*, 569 N.E.2d at 641-42.

19. *RESTATEMENT (SECOND) OF TORTS* § 332 (1965). Indiana courts recognize this category of "public invitees." *See Fleischer*, 504 N.E.2d at 323-24 (court adopts "public invitee" category and holds that members of a congregation are public invitees while on synagogue premises).

inspect land encompassed by an invitation for concealed dangers, and warn invitees of the discovered dangers.<sup>20</sup>

Landholders are not guarantors or insurers of invitees' safety under all circumstances. Curtailment of a landholder's duty of care with respect to natural conditions is particularly relevant to outdoor recreational activities. Natural conditions on the land, such as streams, gullies, or trees, may create hazards to recreational users. In general, a landholder is not required to eliminate these hazards, and invitees are expected to use ordinary care in avoiding the hazards.<sup>21</sup>

The threshold determination of an entrant's status is not always simple. Some jurisdictions have ruled that trespassers who habitually enter another person's land are entitled to the standard of care owed licensees. This rule rests on notions of implied consent of the landholder and on the foreseeability of frequent entrants on the land.<sup>22</sup>

Distinguishing licensees from invitees is even more difficult. States have adopted differing definitions of "invitee." In addition, many courts apply a case-by-case factual analysis to determine the point at which social guests have rendered services for a host that are sufficient to transform guests from licensees into invitees. The following cases illustrate the results when courts apply different analyses. In *Sutton v. Sutton*,<sup>23</sup> a Georgia court held that the status of a son visiting his father's farm changed from social guest-licensee to invitee when the son helped capture a bull. The court held that chasing a bull was a substantial task.<sup>24</sup> Alabama follows the rule that a business invitee is one who enters another's property for a purpose that is of material or commercial benefit to the landholder.<sup>25</sup> Under this definition, a son who dismantled

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20. See 3 J. LEE & B. LINDAHL, MODERN TORT LAW § 39.09 (rev. ed. 1988).

21. Courts rely on various legal doctrines to avoid holding landholders liable for natural conditions. For example, in *Batzek v. Betz*, 519 N.E.2d 87 (Ill. App. Ct. 1988), a 14-year-old boy was rendered a quadriplegic when he fell from a tree in a commercial campground. The court first noted that because the tree was a natural condition on the land, the landholder may have no duty to protect an entrant from inherent dangers of trees. The court then ruled that, even in the absence of a special rule abolishing a duty of care for natural conditions, under ordinary negligence rules no one could reasonably suggest that landholders are required to chop down trees, fence them, or otherwise protect against the possibility that a child will climb one of them and fall. *Id.* at 89-90.

In many states, landholders are liable for harms arising from artificial conditions on the land, but not for natural conditions or man-made features with natural characteristics, such as farm ponds. See, e.g., *Lohrenz v. Lane*, 787 P.2d 1274 (Okla. 1990); see generally 1 N. HARL, AGRICULTURAL LAW § 4.09 (1990).

22. See, e.g., *Libby v. West Coast Rock Co.*, 308 So. 2d 602, 604 (Fla. Dist. Ct. App. 1975).

23. 243 S.E.2d 310 (Ga. Ct. App. 1978).

24. *Id.* at 312.

25. See *Grider v. Grider*, 555 So. 2d 104 (Ala. 1989).

a deck attached to his father's house, without monetary compensation, was found to have provided a material benefit to his father.<sup>26</sup> Therefore, the son was as an invitee for tort purposes.<sup>27</sup>

Recently, the Indiana Supreme Court, in a quartet of cases led by *Burrell v. Meads*,<sup>28</sup> ruled that invitees are those persons on a premises pursuant to an express or reasonably implied invitation. This ruling abolishes the distinction between social guests and commercial visitors and classifies social guests as invitees for purposes of premises liability. As invitees, social guests are entitled to a duty of reasonable care from landholders.<sup>29</sup> Before this ruling, Indiana courts generally followed the rule that social guests were transformed from licensees to invitees only if they were invited onto the host's premises to further the host's business interests or to provide a pecuniary benefit to the host.<sup>30</sup> This economic benefits test had previously been eroded by *Fleischer v. Hebrew Orthodox Congregation*,<sup>31</sup> in which the third district of the Indiana Court of Appeals classified as invitees persons who are invited to enter or remain on land as a member of the public for a purpose for which the land is held open to the public. In *Burrell*, the Indiana Supreme Court not only adopted an "invitation test" for defining invitees, but also explicitly approved the ruling in *Fleischer*, which extends a duty of reasonable care towards public invitees.<sup>32</sup>

2. *Minority Rule: Standard of Reasonable Care Toward Entrants.*—In 1968, the California Supreme Court reviewed the development of premises liability law under the traditional status-based classifications.<sup>33</sup> The court noted that California courts had fashioned many exceptions to the status-based distinctions. These exceptions included landholder liability for a landholder's active negligence and for the maintenance of hidden dangers that constitute traps. The court concluded that the exceptions and refinements rendered the law confusing and that the historical justifications for the status distinctions, which arose from concerns

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26. *Id.* at 105.

27. *Id.*

28. 569 N.E.2d 637 (Ind. 1991), *reh'g denied* (June 3, 1991); *accord Parks v. Parks*, 569 N.E.2d 644 (Ind. 1991); *Risk v. Schilling*, 569 N.E.2d 646 (Ind. 1991); *LeLoup v. LeLoup*, 569 N.E.2d 648 (Ind. 1991).

29. *Burrell*, 569 N.E.2d at 643. Under Indiana law, a landholder owes a licensee a duty to refrain from willfully or wantonly injuring the invitee or acting in a manner to increase the invitee's peril and a duty to warn the licensee of any latent dangers on the premises which are known to the landholder. *Id.* at 639.

30. *Id.* at 640-42.

31. 504 N.E.2d 320 (Ind. Ct. App. 1987), *trans. denied*, 539 N.E.2d 1 (Ind. 1989).

32. 569 N.E.2d at 641-42.

33. *Rowland v. Christian*, 443 P.2d 561, 70 Cal. Rptr. 97 (Cal. 1968).

of large landholders in feudal England, do not apply to modern urban society.<sup>34</sup>

Rather than continue to carve out exceptions to the status-based doctrine, the *Rowland* court adopted a new standard of premises liability grounded in ordinary negligence principles. Under this standard, the status of the entrant is only one of many factors for a court to consider in determining the extent of landholder liability for injuries on the premises. Other major factors include the foreseeability of harm to the plaintiff; the degree of certainty that the plaintiff has suffered harm; the closeness of the connection between the injury and the defendant's conduct; the moral blame attached to the defendant's conduct; the extent of the burden to the defendant and the consequences to the community of imposing liability; the policy of preventing future harm; and the prevalence, cost, and availability of insurance for the risk involved.<sup>35</sup>

Subsequently, California courts have read *Rowland* as providing that the prime concern in premises liability is the foreseeability of the risk of harm.<sup>36</sup> The courts have also emphasized that in some cases the status of the entrant may still determine liability. An entrant's status is relevant to the issue of the foreseeability of injury and to the determination of whether the landholder acted in a reasonable manner toward the plaintiff.<sup>37</sup>

Seven states have followed *Rowland*, and currently apply ordinary negligence rules to premises liability cases.<sup>38</sup> Nine other states apply

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34. *Id.* at 567, 70 Cal. Rptr. at 100-02.

35. *Id.* at 567, 70 Cal. Rptr. at 100, 103.

36. See, e.g., *McDaniel v. Sunset Manor Company*, 269 Cal. Rptr. 196, 199 (Cal. Ct. App. 1990).

37. See, e.g., *Williams v. Carl Karcher Enterprises*, 227 Cal. Rptr. 465, 468-69 (Cal. Ct. App. 1986).

38. Courts in Alaska, Hawaii, Louisiana, New Hampshire, New York, Montana, and Rhode Island have adopted a standard of reasonable care toward all entrants. See *Lohrenz v. Lane*, 787 P.2d 1274, 1276 (Okla. 1990) (Oklahoma Supreme Court reviewed decisions of other state courts before deciding to reject *Rowland* rule); see also Annotation, *Modern Status of Rules Conditioning Landowner's Liability Upon Status of Injured Party as Invitee, Licensee, or Trespasser*, 22 A.L.R.4TH 294 (1983 & Supp. 1990). Colorado premises liability law appears to have endured the most extensive changes in recent years. In 1971, the Colorado Supreme Court abolished common law status distinctions as the measure of liability and adopted the *Rowland* standard. *Mile High Fence Co. v. Radovich*, 175 Colo. 537, 489 P.2d 308 (Colo. 1971). Fifteen years later, the Colorado General Assembly abrogated *Mile High Fence* by adopting a statute intended to restore the traditional premises liability rules. COL. REV. STAT. ANN. § 13-21-115 (West 1989). The new statute interchanged the traditional duty of care owed to invitees with that owed to licensees. In 1989, the Colorado Supreme Court held that the statute was unconstitutional because it violated equal protection guarantees of both the federal and Colorado state constitutions. The court found that the statute bore no rational relation to the legitimate governmental interest in promoting responsibility of landowners and entrants because its classification

ordinary negligence principles in cases involving invitees and licensees, but retain a lowered standard of care for trespassers.<sup>39</sup>

### *B. Activities of the Landholder*

Some jurisdictions that follow traditional status-determinative premises liability rules have carved out an exception for injuries to entrants arising from a landholder's negligent activity.<sup>40</sup> This active negligence exception is used primarily to compensate licensees whose presence was known to the landholder for injuries caused by the landholder's negligent conduct. The threshold determination is whether the licensee's injury arose from the landholder's activity conducted on the premises. If so, ordinary negligence principles apply. If an injury arose from the landholder's "passive" failure to inspect the land for hazards or improve conditions on land, the traditional status rules apply.<sup>41</sup>

An Oregon court applied this doctrine in *Mounts v. Knodel*,<sup>42</sup> a case in which a social guest-licensee was injured by falling from a horse. The plaintiff alleged that the fall was caused by defective riding equipment that the landowner had provided. The court ruled that the maintenance and provision of the equipment was not a condition of the land subject

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scheme gave licensees a higher degree of protection than invitees. The classification scheme could not be justified either historically or logically. *Gallegos v. Phipps*, 779 P.2d 856, 862-63 (Colo. 1989). In 1990, the Colorado General Assembly amended § 13-21-115 by requiring that landholders exercise reasonable care in protecting invitees against dangers about which landholders actually knew or should have known. The statute provides an exception for invitees on land designated as agricultural or vacant land for property tax purposes. In that case, the landholder need only warn the invitee of dangers that are actually known to the landholder. *COL. REV. STAT. ANN.* § 13-21-115 (West Supp. 1990).

39. Courts in Florida, Maine, Massachusetts, Minnesota, Oregon, North Dakota, Tennessee, and Wisconsin have abandoned the distinction between invitees and licensees who are lawfully on the premises and apply a standard of reasonable care under the circumstances towards these entrants. *See Lohrenz*, 787 P.2d at 1276 n.11 (Note that Florida retains uninvited licensees as a distinct category. *See Wood v. Camp*, 284 So. 2d 691, 695 (Fla. 1973)); Annotation, *Modern Status of Rules Conditioning Landowner's Liability Upon Status of Injured Party as Invitee, Licensee, or Trespasser*, 22 A.L.R.4TH 294 (1983 & Supp. 1990). The Illinois Premises Liability Act abolishes the traditional common law distinction between invitees and licensees and provides that the duty of care owed to these entrants is reasonable care under the circumstances regarding the state of the premises or acts done or omitted on the premises. *ILL. ANN. STAT.* ch. 80, para. 302 (Smith-Hurd 1987).

40. *See, e.g.*, *Bowers v. Ottenad*, 240 Kan. 208, 729 P.2d 1103 (Kan. 1986). *But see Fort Wayne National Bank v. Doctor*, 272 N.E.2d 876, 882 (Ind. Ct. App. 1971) (court expressly overrules adoption of active negligence doctrine for landholder's conduct toward licensee).

41. *Bowers*, 729 P.2d at 1103-04.

42. 730 P.2d 594 (Or. Ct. App. 1986).

to premises liability rules.<sup>43</sup> Instead, the court ruled that the provision of equipment was an activity on the land, and under Oregon law the landholder had a duty to exercise reasonable care in the conduct of activities for the protection of licensees.<sup>44</sup>

### C. Domestic Animals

When recreational users are allowed access to agricultural land, the possibility exists that they will be injured by domestic animals that are part of an agricultural or recreational enterprise operated by the landholder. A plethora of common law tort theories are applied when domestic animals owned or controlled by a landholder injure entrants. Additionally, many states have adopted legislation that controls cases involving injuries caused by various classes of domestic animals, particularly dogs.<sup>45</sup>

Under the common law rules of some states, the owner or keeper of a domestic animal is liable for injuries the animal caused only if the plaintiff was lawfully on the premises and can prove that the owner had knowledge of the animal's dangerous propensities that caused the harm.<sup>46</sup> This knowledge falls into two categories: (1) general knowledge about the behavior of a class of animals to which the animal belongs; and (2) knowledge about the circumstances and individual past behavior of a particular animal.<sup>47</sup> An injured plaintiff must show that the defendant knew or should have known of the animal's propensity for behavior that caused the plaintiff's harm. Once this showing is made, the defendant is strictly, or absolutely, liable for the plaintiff's injuries.<sup>48</sup>

Other states apply two separate common law tort theories to cases involving domestic animals. If the plaintiff shows that the owner knew or should have known that the animal had a propensity to commit the particular type of mischief that was the cause of harm, the defendant is strictly liable for the harm.<sup>49</sup> In the alternative, even if the owner or keeper is unaware of any mischievous propensity on the animal's part, the owner is liable in negligence for failing to exert reasonable care in controlling the animal or preventing harm caused by the animal.<sup>50</sup> The

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43. *Id.* at 596.

44. *Id.* (quoting the ruling in *Ragnone v. Portland School District No. 1J*, 291 Or. 617, 633 P.2d 1287 (1981)). *But see Pahanish v. Western Trails, Inc.*, 69 Md. App. 342, 517 A.2d 1122 (1986) (court applies premises liability doctrine to assess landholder's liability for provision of allegedly defective riding equipment).

45. For a comprehensive summary of the law governing liability for injuries caused by animals, see 3 J. LEE & B. LINDAHL, *MODERN TORT LAW* §§ 37.01-.19 (rev. ed. 1990).

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

plaintiff must show that the defendant did not exercise effective control of the animal in a situation in which it would be reasonably expected that injury would occur. The amount of control is that which would be exercised by a reasonable person based upon the total situation at the time, including the past behavior of the animal and the foreseeability of injuries.<sup>51</sup>

Some state courts have expressly rejected the adoption of tort rules narrowly tailored to domestic animal injuries, and instead have widened the scope of premises liability to include risks arising from the presence of domestic animals on the land.<sup>52</sup> In *Sendelbach v. Grad*,<sup>53</sup> a case of first impression, the North Dakota Supreme Court declined to adopt a strict liability standard for injuries caused when defendant's farm dog bit a person who was on the farm premises to buy eggs. The court noted that a strict liability standard would increase the liability of the landholder for the acts of a domestic animal that was useful to the farming operation.<sup>54</sup> The court reasoned that applying strict liability in this situation would ignore both the utility of the animal and a commonsense balancing of all interests concerned.<sup>55</sup>

A number of states have enacted legislation that supersedes the common law by providing that an animal's owner is strictly liable for unprovoked injuries to persons lawfully on the premises which are caused by domestic animals, even if the owner had no knowledge of the animal's vicious or dangerous behavior.<sup>56</sup> Florida's statute provides absolute li-

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51. See *Pahanish v. Western Trails, Inc.*, 69 Md. App. 342, 357-58, 517 A.2d 1122, 1129-30 (1986).

52. See, e.g., *Sutton v. Sutton*, 243 S.E.2d 310, 313 (Ga. Ct. App. 1978) (ruling that premises liability doctrine is not restricted to purely physical defects in real property, but also encompasses risks upon the premises in the nature of vicious animals or ill-tempered individuals likely to inflict harm).

53. 246 N.W.2d 496 (N.D. 1976).

54. *Id.* at 500.

55. *Id.* at 500-01. The court further ruled, however, that a domestic dog with dangerous propensities falls within the "hidden peril" exception to the standard of care owed to licensees. Under this exception, a landholder has a duty to warn licensees of dangers known to the landholder but not open to the licensee's observation. *Id.* at 501. This ruling was made superfluous by *O'Leary v. Coenen*, 251 N.W.2d 746 (N.D. 1977), in which the North Dakota Supreme Court adopted a uniform standard of care toward licensees and invitees.

56. See 3 J. LEE & B. LINDAHL, MODERN TORT LAW § 37.07 (rev. ed. 1990). Illinois's Animal Control Act reads, in part:

If a dog or other animal, without provocation, attacks or injures any person who is peaceably conducting himself in any place where he may lawfully be, the owner of such dog or other animal is liable in damages to such person for the full amount of the injury sustained.

ILL. STAT. ANN. ch. 8, para. 366 (Smith-Hurd 1975).

Under the Act, a plaintiff must show: (1) an injury caused by an animal owned by

ability for injuries caused by dogs, but also provides for an absolute defense if the owner prominently displays on the premises a sign with the words "Bad Dog."<sup>57</sup>

### III. LANDHOLDER LIABILITY UNDER RECREATIONAL USE STATUTES

To encourage recreational access to private lands, as of 1987, forty-eight states had adopted legislation limiting the liability of landholders for injuries to recreational entrants on their land.<sup>58</sup> Many of these statutes are based on a 1965 Model Act drafted by the Council of State Governments;<sup>59</sup> however, states have tailored their statutes to meet local needs and to comply with state public policy concerns.

Under most recreational use statutes, a landholder who charges a fee for access or recreational activity is not protected by the statute, even if the fee covers only the costs of allowing access, with no profit to the landowner.<sup>60</sup> In addition, an injury that arises from a particular recreational activity, for which there is no charge, may result in liability if the landholder receives indirect pecuniary benefits from the recreational activity. For example, a landholder who does not charge for entry to the land but provides recreational equipment for a fee may be disqualified from using the statute as a defense in an action alleging injuries arising from the conditions of the land.<sup>61</sup>

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the defendant; (2) a lack of provocation; (3) the peaceable conduct of the plaintiff; and (4) the presence of the injured person in a place where he has a legal right to be. *See, e.g.*, *Robinson v. Meadows*, 203 Ill. App. 3d 706, 561 N.E.2d 111 (Ill. Ct. App. 1990) (provides comprehensive discussion of meaning of "provocation" under the Illinois Animal Control Act).

57. *FLA STAT. ANN. § 767.04* (West 1986).

58. Alaska has never adopted a recreational use statute. North Carolina repealed a comprehensive statute in 1980, and in 1987 adopted a law limited to the North Carolina Trail System. For a summary of these statutes, see B. VAN DER SMISSSEN, *RECREATIONAL USER STATUTES* (1988) (available from the American Motorcyclist Association).

59. COUNCIL OF STATE GOVERNMENTS, *Public Recreation on Private Lands: Limitations on Liability*, XXIV SUGGESTED STATE LEGISLATION 150 (1965).

60. A number of states do allow limited compensation under their recreational use statutes. For example, Arkansas excludes the following from the definition of charges, which if included would void the application of its statute: (1) the "sharing of game, fish, or other products of recreational use;" and (2) "[c]ontributions in kind, services, or cash paid to reduce or offset costs and eliminate losses from recreational use." *ARK. STAT. ANN. § 18-11-302(4)* (1987). New Hampshire's statute expressly provides that landowners who receive remuneration for pick-your-own or cut-your-own produce operations are liable only for willful, wanton, or reckless conduct toward the entrants. *N.H. REV. STAT. ANN. § 508:14* (1983). Some states, including Indiana, extend the statute's benefits to landholders who receive state or federal monetary remuneration for providing recreational access. *IND. CODE § 14-2-6-3* (1989).

61. *Cf. Douglas v. Dewey*, 453 N.W.2d 500, 505 (Wis. Ct. App. 1990) (plaintiff

In general, recreational use statutes limit the landholder's duty of care to recreational entrants to that duty of care owed by landholders to trespassers under common law premises liability principles. The landholder must refrain from wilful, malicious, or wanton acts toward the recreational entrants, but need not keep the premises safe for the use of the entrant or warn of dangerous conditions on the premises.<sup>62</sup>

States differ on the degree of public access that landholders must allow in order to qualify for the statute's protection. At a minimum, landholders must hold the land open to some members of the general public in order to receive the benefits of the statute. The Kentucky Supreme Court has ruled that to benefit from the state's recreational use statute, a landholder must show that he knew of and condoned the public's recreational use of the property.<sup>63</sup> The landholder's words, actions, or lack of action must infer that the landholder intended to permit the use.<sup>64</sup> Courts in Illinois and Pennsylvania have ruled that a landholder need not open the land to all members of the public at all times.<sup>65</sup> Louisiana's recreational use statute expressly provides that a landholder

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was injured diving from a dock on defendant's resort property; defendant did not charge for the swimming activity, but court ruled that indirect pecuniary benefits from swimming, including charges for other recreational activities on the property, should be assessed to determine if defendant is disqualified from the immunity of the recreational use statute), *review denied*, 454 N.W.2d 805 (Wis. 1990); *Seminara v. Highland Lake Bible Conference, Inc.*, 112 A.D.2d 630, 492 N.Y.S.2d 146, 149 (N.Y. App. Div. 1985) (defendant may be denied recreational use immunity defense if plaintiff shows nexus between recreational activity giving rise to injury and another activity for which consideration was given to defendant).

62. See COUNCIL OF STATE GOVERNMENTS, *Public Recreation on Private Lands: Limitations on Liability*, §§ 3, 4, in XXIV SUGGESTED STATE LEGISLATION 150 (1965). Some states retain higher standards of care for specified categories of entrants. For example, Indiana's statute expressly does not affect the preexisting law of liability concerning business invitees in commercial establishments and invited guests. IND. CODE § 14-2-6-3 (1989).

63. *Coursey v. Westvaco Corp.*, 790 S.W.2d 229, 232 (Ky. 1990).

64. *Id.*; see also *Crawford v. Tilley*, 780 P.2d 1248, 1251 (Utah 1989) (landholders who have not made their property available to at least some members of the general public for recreational purposes may not invoke the protection of Utah's Landowner Liability Act).

65. *Gallo v. Yamaha Motor Corp., U.S.A.*, 363 Pa. Super. 308, 315, 526 A.2d 359, 363-64 n.7 (1987) (landholder need not directly or indirectly invite public to use land in order to benefit from recreation use statute), *appeal denied*, 517 Pa. 623, 538 A.2d 876 (1988); *Johnson v. Stryker Corp.*, 388 N.E.2d 932, 934-35 (Ill. App. Ct. 1979) (agricultural landholders cannot afford to keep their land open to all members of the public at all times). For a discussion of the difficulty of determining how much access is enough access, see *Le Poidevin v. Wilson*, 330 N.W.2d 555, 563 (Wis. 1983) (inviting occasional social guests onto the land was not sufficient public access to afford landholder protection of recreational use statute). Note that Wisconsin's recreational use statute was subsequently amended to incorporate the ruling in *Le Poidevin*. WIS. STAT. ANN. § 895.52(6)(d) (West Supp. 1990).

may limit the use of the land to "persons other than the entire public" by granting a lease, right of use, or other right of occupancy to a selected group of recreational users.<sup>66</sup>

Even with the protection of recreational use statutes, landholders are exposed to tort liability costs. The statutes serve as an affirmative defense to personal injury lawsuits.<sup>67</sup> A landholder may incur significant initial costs in defending a lawsuit.

#### IV. ADEQUACY OF CURRENTLY HELD INSURANCE POLICIES

Agricultural landholders have valid concerns about increased liability exposure if they allow recreational users on their land. As the previous discussion indicates, landholders who restrict access to their land have less exposure to tort liability than do landholders who permit access. Landholders who charge fees for recreational access not only incur the highest liability exposure, but in most states they also lose the limited liability immunity of recreational use statutes. Agricultural landholders who wish to increase the income from their land by charging fees for recreational access must manage the risks of liability exposure.

Insurance provides a means for managing financial risk for personal injury liability if the landholder's policy adequately covers the risks that arise with recreational access. An initial question is whether liability

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66. LA. REV. STAT. ANN. § 9:2791 (West Supp. 1991). This 1989 amendment to the statute appears to abrogate *Peterson v. Western World Insurance Co.*, 536 So. 2d 639, 643 (La. Ct. App. 1988), *writ denied*, 541 So. 2d 858 (La. 1989), in which the court ruled that a private hunting club, which leased land for recreational purposes, was not entitled to the benefits of the state's recreational immunity statute because the club limited the use of the land to its members.

Conversely, too much recreational use may also disqualify a landholder from a statute's protection. In *Logan v. Old Enter. Farms, Ltd.*, 544 N.E.2d 998, 1106-07 (Ill. App. Ct. 1989), the court ruled that if land is used exclusively for recreational purposes, the landholder may not qualify for the recreational use statute. The court reasoned that the legislature intended to provide an incentive for landholders to allow recreational access on a casual basis and that landholders who use land only for recreational purposes do not need the incentive of limited liability to open up their lands to recreational use. *Id.* at 1106-07. Note that this ruling is apparently rendered moot by the Illinois Supreme Court's decision on appeal which reversed the case on other grounds. *Logan v. Old Enter. Farms, Ltd.*, 139 Ill. 2d 229, 241, 564 N.E.2d 778, 784 (1990). In contrast, the California Supreme Court recently ruled that the California recreational use statute, CAL. CIV. CODE § 846, applied to land in a national forest that was subject to a grazing permit but also publicly owned and open to the public for recreational purposes. *Hubbard v. Brown*, 785 P.2d 1183, 1185-86, 266 Cal. Rptr. 491, 495 (1990).

67. See, e.g., *Golding v. Ashley Central Irrigation Co.*, 793 P.2d 897, 899 (Utah 1990) (recreational use statute is used as an affirmative defense, which does not necessarily prevent a lawsuit but may support a motion to dismiss on the pleadings).

policies typically held by agricultural landholders are adequate to insure against risks associated with recreational access.

#### *A. Standard Farmer's Comprehensive Liability Insurance*

Farmer's Comprehensive Liability Insurance (FCLI)<sup>68</sup> policies are designed to provide protection against risks that are peculiar to farming activities. The policies are essentially homeowner's liability policies tailored to the special needs and requirements of persons who live in rural areas and generally engage in agricultural activities that are carried on in rural areas.<sup>69</sup>

FCLI generally covers the insured's liability for injuries to persons who are on the insured's premises with the permission of the landholder, unless the liability is otherwise excluded from coverage. A business pursuits exclusion is typical of most FCLI policies or endorsements. Indeed, the policies are written so that farming activity, the major focus of the policies, is included as an exemption to this exclusion. The exclusion provides that coverage does not apply to bodily injury or property damage arising out of business pursuits of any insured except (a) farming; and (b) activities that are ordinarily incident to nonbusiness pursuits.<sup>70</sup>

FCLI policies do not include a comprehensive definition of the term "farming."<sup>71</sup> Not surprisingly, the definition of "farming" has been a major litigation issue. In the absence of a definition within the policy, courts have turned to sources such as dictionaries, zoning laws, and tax laws for a definition of the term.<sup>72</sup> These sources focus primarily on

68. This section draws on information gleaned from various policies and the cases of a number of jurisdictions. The discussion encompasses both ranch and farm enterprises. The actual coverage of any particular policy depends on the exact language of the policy, the intent of the parties, and the laws and regulations of the appropriate jurisdiction. Before allowing recreational access to their land, landholders should consult their insurance agents or brokers, as well as attorneys, to determine the scope of liability coverage provided by specific policies.

69. *Wint v. Fidelity & Casualty Co. of New York*, 507 P.2d 1383, 1389, 107 Cal. Rptr. 175, 181 (1973) (Sullivan, J., concurring and dissenting).

70. *Id.*

71. FCLI policies or endorsements may cover specific farm-related enterprises by excluding them from the definition of "business pursuits." For example, "the operation of roadside stands maintained principally for the sale of the insured's farm products" may be expressly exempted from the definition of business pursuits and, therefore, be covered by the policy.

72. These sources may be used to ascertain the understanding of the insurer and the insured at the time the policy was issued. For example, in *Bloss v. Rural Mutual Casualty Insurance Co.*, 70 N.W.2d 602 (Wis. 1955), the court applied a statutory definition of "farming" to determine if mink ranching was a farming activity. Because the statutory definition was not amended to include mink ranching until after the policy was issued, the court held that mink ranching was not a farming activity covered by the policy. *Id.* at 605.

traditional farming activities and do not include recreational access, even in regions where certain recreational activities on agricultural land, such as fee hunting, are common.<sup>73</sup> Courts may also define "farming" to include activities that are not strictly necessary for the basic operation of the farm but are complementary to farming. A court may find that these complementary activities are an integral part of whole farming operations in their jurisdictions. An insured may need to submit evidence of activities commonly engaged in by farmers in the area to show that a nontraditional activity falls within "farming."<sup>74</sup>

The definition of farming is also relevant to accidents involving employees. FCLI policies generally cover the medical expenses of third parties from accidents caused by farm employees.<sup>75</sup> An employee engaged in a recreational enterprise, however, does not qualify as a "farm" employee covered by the policy.<sup>76</sup>

Even if an activity does not meet the definition of "farming," the activity may be exempt from the business pursuits exclusion if the activity is ordinarily incident to nonbusiness pursuits. Courts have devised two tests for distinguishing nonbusiness pursuits from business pursuits. Under the first test, any activity pursued by an insured for profit is a business pursuit, even if the activity does not actually generate profits.<sup>77</sup> Under this test, liability for injuries related to a recreational enterprise intended by the insured to supplement farm income probably would not be covered

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73. One major case, *Wint v. Fidelity & Casualty Co. of New York*, indicates that courts tend to define "farming" narrowly. 507 P.2d 1383, 107 Cal. Rptr. 175 (1973). In *Wint*, the insured operated a for-profit riding academy and horse training and breeding facility. He also pastured his own horse and the horses of others for a fee. The court held that horse pasturing fell within the "farming" exception to the business pursuits exclusion in the insured's FCLI policy. *Id.* at 1387, 107 Cal. Rptr. at 179. Therefore, the policy covered liability arising from an accident that occurred when a horse escaped from the insured's pasture and collided with a car. The court indicated, however, that the "riding club" activity alone may be beyond any reasonable interpretation of farming. *Id.* at 1386-87, 107 Cal. Rptr. at 178-79.

74. *See, e.g., Martin v. Shepard*, 134 Vt. 491, 365 A.2d 971 (1976) (if there is any doubt as to whether Vermont farmers commonly engage in a specific activity, trial court must consider evidence on the question and cannot take judicial notice of the fact).

75. *See, e.g., IMT Ins. Co., Farmers Comprehensive Personal Liability Policy* (Policy provisions pt. 1, Form No. 400A-1, eff. 1-87, rev. 11-89) at 2 (on file at the Indiana Law Review office). FCLI policies may also cover "domestic employees" who perform duties related to the care and use of the insured premises. *Id.* at 1.

76. *Id.* ("farm employee" is narrowly defined as an employee whose duties are in connection with the farming operations of the insured).

77. *See, e.g., Heggen v. Mountain West Farm Bureau Mut. Ins.*, 220 Mont. 398, 715 P.2d 1060 (Mont. 1986) (steer roping contests conducted three or four times per year at an arena on the insured's ranch were business pursuits, even though the insured made no profits from the contests).

by the policy. Other jurisdictions have adopted an alternative test that requires an additional element of continued and regular activity before a profit-motivated activity is excluded from coverage.<sup>78</sup>

The business pursuits exclusion does not appear to exclude FCLI coverage for liability arising from injuries to gratuitous entrants on the land. Accidents resulting from farming operations would be covered under the "farming" exemption. If no fee or other compensation is required for recreational entry, the recreational activity on the land is not a business pursuit. If a landholder wants to significantly increase income from the land by charging for recreational access or recreational amenities, however, liability for injuries to recreational entrants could be perceived as arising from a business pursuit that FCLI policies do not cover.<sup>79</sup>

Some insurance companies issue farm and ranch policies that include liability coverage for specified activities, such as fee hunting, that typically provide supplemental income to farming operations. Usually, there is a cap on the amount of supplemental income allowed under the policy. If the cap is exceeded, the activity is viewed as a nonfarming business pursuit excluded from coverage under the policy.<sup>80</sup>

The definition of "premises" covered by an FCLI policy may also determine whether coverage is available for recreational entrants' personal injuries. One of two definitions of "premises" is commonly found in FCLI policies. Premises may be defined functionally as all the locations that the named insured operates as a farm. Land holdings not actively farmed or no longer capable of being farmed may be excluded from coverage. For example, in *Foremost Insurance Co. v. Travelers Insurance Co.*,<sup>81</sup> a clause in a FCLI policy excluded coverage for injury and damage arising out of operation of a snowmobile away from the insured's farm

78. For example, in *Randolph v. Ackerson*, 310 N.W.2d 865 (Mich. Ct. App. 1981), the insured, a farm owner, razed an old barn and sold the wood for profit. A customer loading the wood into a truck was injured. The insured had never before engaged in barn razing and was not engaged in a continuous barn razing business. The court ruled both elements of a two pronged test must be found in order to exclude coverage for the injuries: (1) the insured must have profit motive; and (2) the insured's activity must be a stated occupation or customary engagement. The court held that the second prong of the test had not been met and therefore the "business pursuit" exclusion did not apply. *Id.* at 866-67.

79. A landowner who allows even occasional, gratuitous recreational access should at a minimum question his or her insurance agent or broker about the adequacy of FCLI coverage for this access and should obtain a written opinion from the agent or broker as to the adequacy of coverage.

80. N. Hamilton, *Pheasants Galore: An Innovative Program of Private Fee Hunting*, at 3 (unpublished manuscript) (on file at the Indiana Law Review office).

81. 388 N.Y.S.2d 402 (N.Y. App. Div. 1976).

premises. Applying a functional definition of premises, the court held that liability arising from a collision between an automobile and a snowmobile operated by the insured's daughter on a road that bisected the insured's farm was not covered by the policy.<sup>82</sup> Although the location of the accident was included in the deed description that conveyed title of the farm to the insured, the location had been used as a public highway for ten years and was maintained by the county. The court found that the location was no longer available to the insured for farm purposes, and therefore did not fall within the definition of "farm premises."<sup>83</sup> In *Daire v. Southern Farm Bureau Casualty Insurance Co.*,<sup>84</sup> the plaintiff was injured by falling from the porch of a building used primarily as a fishing camp. The landholder's FCLI policy defined the covered premises as all premises owned and operated by the insured as a farm and other premises for use in connection with a farm. The court held that the "fishing camp" was within the covered premises because the building was used occasionally by farm hands as a cook house. If the building had been used exclusively for recreational activity, the court would have denied coverage under the policy.<sup>85</sup>

Agricultural landholders may want to derive additional income from marginal lands that are not farmed. If a policy uses a functional definition of the premises covered by the policy, the landholder may need additional insurance to cover liability for accidents occurring on land that is not actively farmed but is used by recreational entrants.

As an alternative to a functional definition, some FCLI policies define the premises as a specific geographical location or locations described in the policy's declarations.<sup>86</sup> Injuries occurring on the described premises, and not otherwise excluded from the policy, are covered. Note, however, that policies using either method to define the insured premises usually include an exclusion for any premises upon which a business other than farming is conducted.

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82. *Id.* at 404.

83. *Id.*

84. 143 So. 2d 389 (La. Ct. App. 1962).

85. The *Daire* case is included for the reasoning involved in defining farm premises. The Louisiana legislature adopted a recreational use statute, LA. REV. STAT. § 9:2791 (West 1965), to overcome the decision of the trial court in this case, which held that the landowner was liable for the recreational guest's injuries. See *Holder v. Louisiana Parks Service*, 552 So. 2d 20 (La. Ct. App. 1989).

86. See, e.g., *Dorre v. Country Mutual Ins. Co.*, 363 N.E.2d 464, 465 (Ill. App. Ct. 1977) (insurer had no duty to defend insured against tort action when accident occurred on twelve-acre parcel of land that farmer had not listed on the policy declarations; policy expressly provided that premises owned, rented, or controlled by the insured and not listed in the declarations were excluded from coverage).

### B. Homeowner's Liability Insurance Policy

The standard homeowner's liability insurance policy provides coverage for bodily injuries to persons on the insured premises with the permission of the insured. Liability coverage may be available for injuries arising from a condition in the insured location or immediately adjoining it, from activities of the insured or of a resident employee in the course of the resident employee's employment by the insured, or actions of an animal owned by or in the care of the insured.<sup>87</sup>

A homeowner's liability policy contains a business pursuits exclusion similar to that of the standard FCLI policy. Business pursuits of the insured, other than activities ordinarily incidental to nonbusiness pursuits, are not covered. Farming for profit and other profit-making pursuits may be expressly excluded.<sup>88</sup> Given this exclusion, the standard homeowner's liability policy is inadequate to cover incidents arising from recreational access to agricultural land. If the landholder charges fees for recreational entry, recreational activities would fall within the business pursuits exclusion. Landholders who do not charge fees but who farm for profit would not be covered for bodily injuries to entrants arising from farming activities.

Limitations on the premises covered by the policy are also relevant to liability for recreational access. The standard homeowner's insurance policy covers injuries occurring on vacant land, but may exclude from coverage farm land owned or rented by the insured.<sup>89</sup> A landholder would need to ensure that recreational entrants, including those not charged for entry, confine their activities to vacant land and do not enter farmland.

### C. Automobile Insurance Policy

The standard automobile insurance policy is designed to cover liability arising from injuries that result from the ownership, care, maintenance,

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87. W. FREEDMAN, *supra* note 7, app. K.

88. See, e.g., *Wint v. Fidelity & Casualty Co. of New York*, 507 P.2d 1383, 1386, 107 Cal. Rptr. 175, 178 (1973) (incident in which insured's horse escaped from pasture and collided with car was within business exclusion of homeowner's policy because farm on which horse was kept was operated for profit). Note that a homeowner's policy may cover incidents occurring on the premises of a farm operation if the incident does not arise out of a circumstance related to the farm enterprise. For example, in *Lititz Mutual Insurance Co. v. Branch*, 561 S.W.2d 371 (Mo. Ct. App. 1977), the court held that the insured's homeowner's policy covered injuries to a child bitten by a dog at the insured's dairy farm. The court found that the dog was not on the dairy property for a business purpose, such as guarding the premises. The court further found that the incident did not arise out of the dairy business, but out of the insured's personal conduct in harboring a vicious dog. Therefore, the court concluded that the policy's business pursuits exclusion did not apply. *Id.* at 373.

89. W. FREEDMAN, *supra* note 7, app. K.

operation, or use of the vehicle described in the policy's declarations. If there is any independent, intervening cause of the accident, there is no coverage under the policy.<sup>90</sup> Given these limitations on liability coverage, the standard automobile insurance policy is inadequate to cover all potential liability arising from recreational access, even if there is no charge for access.

## V. SPECIALIZED INSURANCE AND RISK MANAGEMENT ALTERNATIVES

Insurance policies typically carried by rural landowners do not adequately cover liability risks associated with allowing regular recreational access. In the case of gratuitous recreational access, even if the circumstances giving rise to injuries to recreational users are covered by a policy, the amount of the coverage may not be sufficient to pay the full amount of potential damages. If an agricultural landholder supplements income from the land by charging for recreational access, exclusions in the policies may preclude coverage. Agricultural landholders need to look beyond the typical policies for a means of managing the financial risks associated with recreational access.

### A. *Excess Insurance and Umbrella Policies*

If liability exposure from the type of risks arising from recreational access is adequately covered by a currently held policy, the landholder may increase the amount of coverage by obtaining an excess insurance policy. Excess insurance supplements the amount of coverage of an underlying primary policy. Excess insurance does not provide coverage until the amount of coverage of the primary policy is exhausted. This approach provides a relatively simple insurance solution for a landholder who is willing to provide recreational access for no charge but is concerned about the possibility of serious, costly injuries to recreational users.<sup>91</sup>

If currently held policies do not completely cover the risks associated with recreational access, the landholder may supplement the primary insurance with an umbrella policy. Umbrella policies supplement the

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90. W. FREEDMAN, *supra* note 7, § 1:22.

91. For a review of issues concerning excess insurance, see Marick, *Excess Insurance: An Overview of General Principles and Current Issues*, 24 TORT & INS. L.J. 715 (1989). Excess insurance designed to supplement specific underlying primary policies in a co-ordinated package of insurance coverage is referred to as "following form" excess insurance. The following form policy provides that the exact same risks are covered by the policy as are covered by the primary insurance. The premiums for this excess insurance are less than those of the primary insurance because (1) the excess insurer has no duty to defend the insured; and (2) the risk of a claim against the excess insurance is decreased by the coverage of the primary insurance. *Id.* at 718.

amount of coverage of underlying primary policies and also provide coverage for additional types of risks.<sup>92</sup> This additional risk insurance is essentially specialty insurance, which can be tailored to the particular type of recreational opportunity provided by the landholder.

### *B. Specialized Insurance Carried by the Landholder*

Specialty insurance is available for many specific recreational opportunities and services.<sup>93</sup> A landholder may need to persist to find specialty insurance in light of the perception that such insurance simply does not exist.<sup>94</sup> Liability insurance coverage for fee recreational activities is generally written in the amount of \$100,000, \$300,000, \$500,000, or \$1,000,000. Premium rates are based on a combination of factors, including the exposure of risk for a particular recreational activity, the amount of acreage devoted to the recreational use, the number of recreational users having access to the premises, and the managerial expertise of the operator of the recreational enterprise. Actual cost may be assessed as a set fee or based on a percentage of gross receipts of the recreational enterprise.<sup>95</sup>

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92. The umbrella-policy insurer has a duty to defend the insured against the additional types of risks that are not covered by the primary insurance. *Id.*

93. Insurance may not be available to the landholder for high risk activities or unusual recreational activities for which actuarial data are not yet available. Insurance for both downhill and cross country skiing enterprises is very difficult to obtain and extremely expensive. As of spring 1989, insurance was not available for risks arising from rock climbing. See Dillard, *Insurance: Questions and Answers Related to Fee Access*, in *PROCEEDINGS*, *supra* note 1, at 396. See also Whiteside, *Insuring Summer Fun, Recreation Cover Abundant*, *Bus. Ins.*, Aug. 21, 1989, at 3 (reporting that the Sierra Club had suspended all club-sponsored mountain climbing trips because it could not afford the premiums for insurance to cover the activity).

94. See, e.g., Lundquist, *Landowners Grapple With Liability Questions*, *AMERICAN FORESTS*, Jan.-Feb. 1989, at 17, 19 (quoting an American Farm Bureau representative as stating, "Neither love nor money can get insurance policies anywhere to protect the small landowner from injuries to recreational users," at the first formal meeting of the Landowner and Recreational Alliance in Washington D.C., June 14, 1988).

95. S. McCLELLAND, D. CLEAVES, T. BEDELL & W. MUKATIS, *MANAGING A FEE-RECREATION ENTERPRISE ON PRIVATE LANDS* 5 (Or. St. U. Extension Service, Extension Circular 1277, Mar. 1989). Specialized insurance is readily available for some common recreational enterprises. For example, insurance rating for fee hunting is based on the amount of acreage leased and the frequency with which groups hunt on the land covered by the policy. Woodward, Long & Reiger, based in New York, sells liability insurance to landowners having both small and large fee hunting tracts. Premiums in 1989 were \$5.50 per hundred dollars of gross hunting receipts, with a \$650 minimum premium. The Davis-Garvin Agency of Columbia, South Carolina sells policies for lease hunting arrangements. For large landowners, premium costs are about 15 cents per acre for tracts over 50,000 acres and 23 cents per acre for tracts in the 10,000 acre range. Premiums

State law may require recreational enterprises to carry a specific amount of liability insurance. For example, Oregon hunting and fishing outfitters and guides must carry liability insurance for occurrences caused by the outfitter or guide and employees that result in bodily injury or property damage. Coverage must be at least \$300,000 per occurrence, general liability insurance or bodily injury coverage must be at least \$100,000 per person to a total of \$300,000, and \$10,000 property damage per occurrence.<sup>96</sup>

Before issuing specialty insurance, insurers may require landholders to provide a high level of recreational services to reduce risk. For example, a ranch charged a \$20 fee for escorting or directing hunters to good elk hunting locations on the ranch and for providing return transportation. The service was provided on a casual basis by employees engaged primarily in working the ranch. A hunter, who became lost in a storm, sued the ranch. The ranch's insurer settled the suit for tens of thousands of dollars. Subsequently, the insurer required that the ranch operate a full-fledged outfitting service as a condition of obtaining insurance.<sup>97</sup>

Specialty insurance may take the form of a rider to an existing policy or a separate policy. If the insurance is a rider, the insurance agent should ascertain that no conflicts exist between the rider and the policy.

### *C. Insurance Carried by the Recreational User*

As an alternative to insurance carried by the landholder, a landholder may require that recreational users carry insurance for the risks of

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issued to hunting clubs cost about \$25 per hunter per year. Patterson & Patterson, *Land Lease: Sporting Rights for "Rent"*, AM. FORESTS, Sept.-Oct. 1989, at 56. The number of bed and breakfast operations is increasing. Liability coverage is readily available, with a fairly low premium rating based on receipts of the operation. A recent Minnesota study indicated that a farm-based bed and breakfast operation, which included short visits and a limited opportunity for guests to see the farming operations, could be covered by an endorsement to an existing farmer's comprehensive liability policy. Estimated premiums for this additional coverage ranged from \$25 to \$80. Insurance companies were also considering providing endorsements, rather than requiring separate policies, for farm vacation businesses offering longer visits and more opportunities to observe farm operations. J. Thompson, Summary Report and Final Recommendations: Farm Based Guest Businesses and Building Minnesota's Agricultural Tourism (unpublished manuscript) (prepared for the Minnesota Governor's Council on Rural Development). Insurance coverage is also readily available for stream and pond fishing, campground operations, and recreational hiking. See Dillard, *Insurance: Questions and Answers Related to Fee Access*, in PROCEEDINGS, *supra* note 1, at 396.

96. OR. REV. STAT. § 704.020(1)(e) (1989).

97. See Huffman, *Can Farmers and Hunters Coexist: Fee Hunting and Other Alternatives*, AGRIC. L. UPDATE, Oct. 1988, at 4.

recreational use. This is a common arrangement between landholders and groups, such as hunting clubs, which lease land for recreational use. As a term of the lease, the landholder requires the lessee to carry liability insurance on both the lessee and the landholder. The lessee's policy should name the landholder as one of the insured parties. This arrangement is typical of other leases already familiar to agricultural landholders, for example landlord-tenant leases or grazing leases.<sup>98</sup>

Recreational users may carry standard liability policies that cover accidents and injuries caused by the recreational user.<sup>99</sup> Special policies or endorsements covering particular recreational activities may be available to the recreational user. For example, snowmobile liability policies providing coverage for injury and damages resulting from ownership and operation of a snowmobile are available.<sup>100</sup>

There are drawbacks to a landholder's relying on insurance carried by recreational users. Ascertaining the insurance coverage of numerous casual or occasional recreational users is a significant burden to a landholder. In addition, the landholder will not have control over legal issues such as the intent of the parties to the insurance policy.<sup>101</sup> Unless the landholder has clearly given control over the premises to a specific group of recreational users, a better strategy is for the landholder to acquire additional liability coverage.

#### *D. Insurance Carried by Recreational "Brokers"*

As demand for recreational access to private land increases, a new type of enterprise, the recreational "broker" has appeared. An example is Pheasants Galore, Inc. located in Iowa. Pheasants Galore enters into an agreement with a landholder under which the landholder grants hunting, shooting, and fowling rights to Pheasants Galore. Then Pheasants Galore, acting as the landholder's agent, enters into separate agree-

98. See D. PINEO, WILDLIFE AND RECREATION MANAGEMENT ON PRIVATE LANDS, A GUIDE FOR WASHINGTON 32 (1985).

99. For example, in *Ermert v. Hartford Insurance Co.*, 559 So. 2d 467 (La. 1990), a hunter negligently shot a fellow hunter in the foot at a hunting camp. The negligent hunter, who was president and majority shareholder of his corporate business, used the camp for entertaining clients and employees and generating business sales. The court found that the negligent hunter was acting in the scope of his employment at the time of the accident. *Id.* at 478. Therefore, the corporate business was vicariously liable and the accident was covered by the insurance policy of the business. The court reached this decision even though it found that the negligent hunter's predominant motive for being at the camp was recreational activity unrelated to employment. *Id.* at 475-78.

100. See *Foremost Ins. Co. v. Travelers Ins. Co.*, 54 A.D.2d 150, 388 N.Y.S.2d 402, 403 (N.Y. App. Div. 1976).

101. For a review of the role of the expectation of the parties in interpreting an insurance contract, see W. FREEDMAN, *supra* note 7, § 11:2[g].

ments with hunters which transfer the hunting, shooting, and fowling rights to the hunters. Pheasants Galore also enters into agreements with providers of bed and breakfast services.

Pheasants Galore has obtained an insurance policy from Grinnell Mutual providing \$500,000 coverage for hunting and \$500,000 coverage for bed and breakfast services. This policy is unique. Currently, Pheasants Galore also encourages individual landholders to carry liability insurance for activities conducted on their land under the agreements with Pheasants Galore.<sup>102</sup>

#### *E. Insurance Carried by Cooperatives or Other Groups*

A single landholder may not have sufficient resources, including surplus land available for recreational use, to run a viable recreational enterprise. Grazing Lands Forum, a consortium of about twenty-five organizations and government agencies interested in management of grazing lands, suggests that landholders pool their resources and share the costs of providing recreational access. The landholder pool can assess cooperating landholders in order to fund a group liability insurance policy. The cost of a group policy to an individual landholder may be considerably less than the cost of an individual policy.<sup>103</sup>

The Six Shooter Hunting District is an example of a landholder pool. The District was formed in 1989 by about a dozen landowners near Rapelje, Montana, who pooled their land for a fee hunting operation. The District charges \$25 to hunters for the privilege of hunting antelope on the District land. Landowners are paid for maintenance and costs. Money from the hunting fees also goes to a community development fund. About 130,000 acres of antelope habitat are included in the District.<sup>104</sup> The District carries an insurance policy, with premiums based on the amount of the revenue generated. The 1989 premium was about \$500 for the group.<sup>105</sup>

The United States Department of Agriculture also has promoted cooperative approaches to providing recreational access. Liability insurance is still a necessity, but joint purchase of insurance through a

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102. N. Hamilton, *Pheasants Galore: An Innovative Program of Private Fee Hunting*, at 3 (unpublished manuscript) (on file at the Indiana Law Review office). If this new recreational brokerage proves successful, it may be possible for Pheasants Galore to carry all necessary insurance for the recreational activities.

103. See *Mixed Uses For Grazing Land Can Yield Extra Income*, FARMLINE, Feb. 1988, at 14.

104. Sands, *Wildlife Payoff*, Agweek, Mar. 12, 1990, at 26, col. 3.

105. *Id.* at 27, col. 1.

cooperative or other association may reduce the members' individual costs.<sup>106</sup>

In organizing a recreational association, care should be taken to ensure that individual landholders are not unexpectedly exposed to liability. As a general rule, the entity with control of property is liable for injuries to entrants. Delegation of property management in some circumstances, however, may not suffice to delegate liability. For example, in *Davert v. Larson*,<sup>107</sup> an individual holder of 1/2500 undivided interest in a ranch and recreation community managed by an owners association was not relieved of liability arising from negligent maintenance of property. The court ruled that tenants in common who delegate control and management of property are not immunized from liability to third parties for tortious conduct.<sup>108</sup> The court noted that California law does not require associations managing common areas to carry insurance to cover injuries to third persons arising from conditions of the common areas.<sup>109</sup> The court reasoned that relieving individual owners in common of liability would eliminate motivation on the part of any party to exercise due care and control of commonly owned property and could leave injured third parties without a remedy at law.<sup>110</sup>

Landholders may wish to retain authority over some aspects of property management, while delegating limited management authority to a recreational association. For example, a rancher may leave the management of fee hunting parties to a recreational association but still retain rights to manage the land for grazing. As a result, a single

106. USDA, AGRICULTURAL COOPERATIVE SERVICE, THE COOPERATIVE APPROACH TO OUTDOOR RECREATION 6 (Coop. Info. Rep. No. 32, 1984); *see also Mixed Uses for Grazing Land Can Yield Extra Income*, FARMLINE, Feb. 1988, at 14 (report on Grazing Lands Forum conference at which participants suggested that cooperating landholders could fund an insurance pool and obtain a less expensive group policy to insure landowners against liability for recreational access).

107. 163 Cal. App. 3d 407, 209 Cal. Rptr. 445 (1985).

108. *Id.* at 412, 209 Cal. Rptr. at 448.

109. *Id.*

110. *Id.* The court noted that the Uniform Common Interest Ownership Act, promulgated by the National Conference of Commissioners on Uniform State Laws, provides that owners are not individually liable for torts arising out of common areas. The Act assigns liability to associations formed to manage the common areas and requires that the associations maintain specified insurance that covers liability for injuries to third parties on the common areas. *Id.* The court noted that the liability of the individual tenants in common is joint and several, but did not reach the issue of apportioning liability among the individual members of the owners association. *Id.* at 406, 209 Cal. Rptr. at 447. In a subsequent case, *Kaye v. Mount La Jolla Homeowners Association*, the court indicated in dicta that members of owners associations are vicariously liable for common area torts, at least to the extent of their pro rata ownership of the common areas. 252 Cal. Rptr. 67, 76-77 (Cal. Ct. App. 1988).

premises may be subject to control and management by both an individual landholder and an association. Both entities could incur liability for injuries to recreational users, and both should take steps to assess their liability exposure and to insure against potential liability risks.<sup>111</sup>

## V. CONCLUSION

Agricultural landholders willing to open their land for recreational access have valid concerns about increased tort liability exposure. This exposure, under both traditional premises liability rules and the modern doctrine of reasonable care toward entrants, increases significantly if the landholder receives compensation for recreational use of the land. Recreational use statutes provide limited immunity for gratuitous use of the land, but in most states the statutes provide no liability immunity if landholders are compensated for the recreational use. Even if the landholder does not charge for use, loopholes and unresolved issues surrounding application of these statutes may involve the landholder in protracted litigation.

Liability insurance policies typically held by agricultural landholders are not written or intended to cover the risks of frequent recreational access. Under most of these policies, coverage is clearly precluded if the landholder opens the land to recreationists with a profit motive, hoping to obtain supplemental income from the land. Specialty insurance is available for many recreational enterprises. Innovative approaches, such as recreational brokerages and cooperatives, can help landholders decrease the costs of managing financial risks. Until the courts have ruled on the liability of individual landholders under these group arrangements, however, individual landholders should obtain insurance policies with specific coverage of the liability risks associated with recreational access.

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111. *See, e.g.*, *Fryberger v. Lake Cable Recreation Association*, 40 Ohio St. 3d 349, 533 N.E.2d 738 (1988) (court denied summary judgment in case involving plaintiff injured by diving into a lake; the court found that a factual issue existed as to whether both the owner of lake front property and the association that managed the lake owed a duty of care to the injured plaintiff for conditions in the lake).

# Recreational Access to Agricultural Land: The European Experience

HELGE WULFF\*

## I. INTRODUCTION

In many European countries, public access to the countryside for recreational and sport uses has become an important issue, especially since the Second World War. The purpose of this Article is to describe European law on the right of public access to the countryside and the means employed by legislatures and administrative agencies to enlarge the right of access in order to meet the increasing demand of the urban population for recreational opportunities.

This Article deals only with public access to privately owned farmland, including forests belonging to farms and watercourses and lakes in agricultural regions. Public access to public lands, to large forest estates, and to the sea and beaches will not be discussed, and only the most important rules will be mentioned.

## II. THE COUNTRIES

Of course, discussing the law of every European country is beyond the scope of this Article; therefore it is limited to the law in England and Wales, France, and three Scandinavian countries, Denmark, Norway, and Sweden. In this way, three legal "families" of Europe are represented in the Article: Common Law, Civil Law, and Scandinavian Law.

To understand the different approaches taken by these countries, it is first necessary to appreciate a few of the differences between the countries themselves. One extreme is Denmark with sixty-five percent of the whole country reserved for farming with intensely cultivated fields (mostly cereals and cash crops) and with comparatively few forests and uncultivated areas left for recreation and sport. Another extreme is Norway and Sweden where only three percent and ten percent of the total area is used for farming. The rest of the country consists mostly of forests and mountainous areas, many of which are publicly owned.

In between are England and Wales, where seventy-five percent of the countryside is farmland. However, unlike Denmark, two-thirds of the farming area is hilly with rough grazing where the presence of the

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public might cause less harm. Additionally, more uncultivated areas exist in England and Wales.

France is characterized by great differences in climate, geography, and farming. This Article primarily addresses the situation in the Mediterranean region of Languedoc-Roussillon. This area consists of mountains (les Cevennes) with a very feeble farm production and plains with a subtropical climate and both large and small vineyards producing forty percent of all French wine and quantities of fruits and vegetables. Near the coast, there is a fast growing tourist industry and an expanding urban area (Montpellier) which increase the demand for public access to the countryside for recreational purposes.

### III. THE LAW ON PUBLIC ACCESS TO PRIVATELY OWNED FARMLAND

In all four countries, the basis of land law is private ownership, but property rights are more or less restricted in order to secure public access to the countryside.

#### *A. Denmark*

Let us turn to the first of the two extremes mentioned above: In Denmark,<sup>1</sup> the farmer is generally master of his own land. Access to his land requires his permission regardless of whether the land is fenced or has crops. The public may use private roads on his land, but the owner can bar them with a gate, forbid passage with a signpost, or even plow them.

These rules, laid down in a 1953 statute,<sup>2</sup> have roots back in the eighteenth and nineteenth centuries when the old feudal system and village communities were abolished by a land reform which also included the transfer of ownership from the large landed estates to the tenants. A new class of independent farmers became owners of their land and wished to farm the land in peace and use new methods of cultivation — undisturbed by neighbors and strangers.

However, the Danish Nature Conservation Act<sup>3</sup> created exceptions to the rules mentioned above. For example, in the daytime hours, people may walk across the farmer's uncultivated land if it is not fenced. They may also use the roads of his forests (above five hectares), but may not

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1. The law on public access to the countryside in Denmark is discussed in: W.E. VON EYBEN: DANSK MILJORET, I-V (GAD, 1977-78); W.E. VON EYBEN: MILJORETTENS GRUNDBOG (AKADEMISK FORLAG, 1986); KARNOVS LOVSAMLING, II OG III, 1989; HELGE WULFF: LANDBORET (DSR, 1979); and HELGE WULFF: SKOVLOVEN (LANDBRUGSMINISTERIET, 1970).

2. Lov om mark og vejfred, lovbekendtgørelse nr. 818 af 11.12. 1987.

3. Lov om naturfredning, lovbekendtgørelse nr. 530 af 10.10. 1987.

roam about in the forest, nor ride a bicycle or a horse, nor drive a car in the forest or on the roads of the forest.

According to the Watercourse Act,<sup>4</sup> lakes and waterstreams with more than one riparian owner are also open for sailing and canoeing, but motorboats are not permitted. The right to fish and hunt on watercourses and lakes belongs to the riparian owners.

### *B. Norway and Sweden<sup>5</sup>*

Let us go to the other extreme: Norway and Sweden. These countries, which in contrast to Denmark are sparsely populated, always have had a customary law — *allemannsretten* — according to which the public has a right of access to privately owned land. In Norway, this customary law has been given a more explicit formulation in a statute: The Open Air Recreation Act of 1957.<sup>6</sup> This statute distinguishes between cultivated and uncultivated land.

Anyone may walk on cultivated land between October 15 and April 30, provided the ground is frozen or covered with snow. Of course, there are exceptions with respect to farmyards, gardens, and similar areas. The farmer also may prohibit any passage that might cause significant damage. Camping, picnicing, sunbathing, and staying overnight is not permitted without the owner's consent.

On uncultivated private land, the public has a right to walk year-round, but riding a horse or a bicycle and sledding are permitted only on roads and in mountains. Camping and picnicing are allowed but only for periods not longer than two days.

A landowner always can forbid the use and parking of motor vehicles on his private roads. The public has no right to fish or hunt in waterstreams and lakes. In addition, sailing is allowed only on navigable waters.

In Sweden, the “*allemannsrett*” is still customary law, but it is also the background to dispositions in various statutes, including the Criminal

4. Lov n.r. 302 af 9.6. 1982 om vandiob.

5. This Article relies on the following literature on Norwegian law: *FRILUFTSLOVEN, HVA LOVEN TILLATER OG FORBYR, UΤGITT AV STATENS FRILUFTSRAD, MILJOVERNDEPARTEMENTET; THOR FALKANGER: EIERRADIGHET OG SAMFUNNSKONTROLL* (Universitetsforlaget, 3. udgave, 1985); and *ST. MELD. NR. 40 (1986)-87, OM FRILUFTSLIV, TILTRADING FRA MILJOVERNDEPARTEMENTET AV 3. APRIL 1987, GODKJEND AV STORTINGET*. The Article relies on the following literature on Swedish law: *ALLEMANNSRATTEN, STATENS NATURVARDSVERK, MEDDELANDE 3/1979; BERTEL BENGSSON: ALLEMANNSRATT OCH MARKAGARSKYDD, (2. uppl., Stockholm, 1966); BERTEL BENGSSON: SPECIELL FASTIGHETS RATT* (Justus Forlag, Uppsala, 1979); *INGVAR CHRISTOFFERSEN OG ERIK SAMUELSEN: ALLEMANNSRAT - NATURVETT, (LTs forlag - LTk)*; and various papers and pamphlets from the Swedish Nature Conservancy Agency.

6. Lov af 28. juni 1957 om friluftslivet (med senere endringer).

and Nature Conservation legislation.<sup>7</sup> Swedish law is similar to Norwegian law, but usually is presented in this way: You may walk, ride, or cycle on all private land with two very important exceptions: You have no access to the area near inhabited buildings, and you must not disturb the peace or in any way interfere with the farmer's right to use his land for farming or for any other kind of production or cause any pecuniary loss or inconvenience to the farmer. Consequently, the public has no right of access to cultivated land unless it is frozen or covered with snow. Camping and picnicing is allowed only for short periods depending on how much it interferes with the farmers' right to peace and a clean area. The owner always can forbid the use of motor vehicles on private roads.

The public has no right to hunt or fish on the farmer's property. There is a public right to sail and bathe in rivers, waterstreams, and lakes.

### *C. England and Wales*

In England and Wales,<sup>8</sup> the law is different from Norwegian and Swedish law. Common law does not recognize a general public right to use private land for recreation.

Throughout history, however, England and Wales have possessed a network of roads and paths to which the public has a right of way recognized by common law. Various statutes contain rules on the maintenance, modification, and closure of such roads that extend 190,000 kilometers.<sup>9</sup>

In England and Wales, three kinds of highways are recognized: footpaths, bridleways, and byways open for all traffic.<sup>10</sup> A footpath is a highway over which the public has a right of way on foot only. A bridleway is a highway on which the public has a right of way on foot and on horseback. Riding of bicycles is allowed on bridleways, but cyclists must give way to pedestrians and persons on horseback. A byway open for all traffic is a right of way for vehicular and all other kinds of traffic, but is used mainly for the purposes for which footpaths and bridleways are used.

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7. BERTEL BENGTSSON, ALLEMANNSRAT OCH MARKAGARSKYDD (2. upp. Stockholm, 1966).

8. This Article is based on the following literature on English law: ACCESS TO THE COUNTRYSIDE FOR RECREATION AND SPORT, REPORT TO THE COUNTRYSIDE COMMISSION AND THE SPORTS COUNCIL BY THE CENTRE FOR LEISURE RESEARCH (1986) [hereinafter ACCESS STUDY]; CLERK AND LINDSELL ON TORTS, Common Law Library No. 3 (Sweet and Maxwell, London, 1989); J. FLEMING, AN INTRODUCTION TO THE LAW ON TORTS (1985); Papers and Booklets edited by the Countryside Commission (CCP No. 186, 227, 234, 235, 259, 265, 266, 273) and publications on the new Rights of Way Act of 1990.

9. ACCESS STUDY, *supra* note 9, at 82.

10. Wildlife and Countryside Act (1981).

Some highways were created in past centuries by the local population. Some are expressly dedicated by the landowner or established by local authorities for reasons other than recreational uses. Some are prescriptive rights — that is, they have come into existence according to the rules of common law because they have been used frequently and openly by the general public as a right for more than twenty years without the landowners' interruption or objection.<sup>11</sup>

Highways are maintained<sup>12</sup> by the highway authorities or by the local authorities; however, a landowner can never, by dedication, compel the authorities to maintain a road. Most highways are recorded in so-called "definitive maps and statements" held by the local councils.<sup>13</sup> If a right of way is shown on a definitive map, it is conclusive proof of its existence in law. If a road is not shown on the map, it still may be a public right of way.

Highways alone are not sufficient to meet the needs of campers and picnickers. These persons need access to larger areas, not just the right to walk along a road. Some heaths and moorlands are traditionally open to the public. In all other areas, access requires the farmer's permission. Many farmers allow the public to enter their lands so long as no harm will occur.<sup>14</sup>

The banks and beds of rivers, waterstreams, and lakes usually are owned by private riparian owners who by common law control the use of the water and whose permission is required for sailing, canoeing, and other water activities. Common law, however, also recognizes a public right of access based on "immemorial use," usually at least forty years. Some waters, which by statutes are classified "navigable," are open to the public for recreation and sport.<sup>15</sup>

#### *D. France<sup>16</sup>*

Under French law, access to property normally requires the owner's permission. According to French authors, this is a consequence of Code

11. Wildlife and Countryside Act 1981; ACCESS STUDY, *supra* note 8, at 72-73.

12. Highway Act (1980).

13. Wildlife and Countryside Act (1981).

14. ACCESS STUDY, *supra* note 8, at 73.

15. ACCESS STUDY, *supra* note 8, at 95, A. TELLING & R. SMITH, THE PUBLIC RIGHT OF NAVIGATION, A REPORT TO THE SPORTS COUNCIL AND WATER AMENITY COMMISSION (1985).

16. This Article is based on the following literature on French law: M. BOUTELET, UN REGIME JURIDIQUE POUR LES CHEMINS DE RANDONNÉE PEDESTRE (Revue juridique de l'environnement 1984.291); Code de l'environnement, redige par Jean Lamargue (3d ed. Dalloz 1990); J.-L. GAZZANIGA, ET J.P. OURLIAC, LE DROIT DE L'EAU (Litec 1979, Supp. 1987); J.-Y. PLOUVIN, LA PROTECTION DES VOIES DE CHEMINEMENT OU LE DROIT A LA

Civil Articles 544 and 547.<sup>17</sup> According to Article 544, a property owner can "dispose of his property in the most absolute manner," and Article 547 gives a landowner the right to "clore" (enclose) his land with a fence or hedge.

Private roads running across a farmer's land generally are closed to the public. There are some roads and paths (*chemins et sentiers d'exploitation*) that adjacent farmers are given the right to use. These roads belong to the owners of the adjacent land, but they are maintained by all users according to their interest in the road. The users may bar the public from using the road.

Of course, this does not mean that the public is prohibited from visiting the countryside. People may use the public roads (*voies publiques*). A number of "country roads" (*chemins ruraux*),<sup>18</sup> originally created for agricultural purposes or to serve as a means of communication between farms, are frequently found in the French countryside. These roads are open to the public without the landowner's consent. The country roads are owned by the municipality which can sell them, often to the owners of the adjacent land. These adjacent owners sometimes acquire the roads by prescription.

As a general rule, the beds and banks of watercourses and lakes belong to the riparian landowners,<sup>19</sup> who also have the exclusive right to use the water for irrigation, drainage, hunting, fishing, and sailing. The riparian owners also can forbid public access and use of the watercourse or lake.<sup>20</sup>

A landowner can transfer his fishing rights to a local authorized fishermen's club. In that case, the club acquires a right of passage along the shore of the watercourse on the condition that it covers any damage to crops caused by the traffic.<sup>21</sup> The general public normally has no special right of access along watercourses and lakes.

Some watercourses and lakes are classified as what might be called "navigable waters" ('*cours d'eau et lacs domaniaux*').<sup>22</sup> The public has the right to use them for sailing, fishing, and, to some extent, walking along the shores.

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PROMENADE, Gazette de Palais 1977.1.281; Starck, Boris: *Droit Civil, Obligations*, 1. Responsabilite delictuelle (par Henri Rolland et Laurent Boyer, 3. 3d. Litec 1985); A. WEILL, TERRE. AND P. SIMLER, *DROIT CIVIL, LES BIENS* (3d ed. Dalloz 1985).

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18. Code Rural Art 59-71.

19. Code Rural Art. 89.

20. Code Civil Art 644; Code Rural Art 98-3, 105, 365, 422.

21. Code Rural 423, 424, loi no. 84-512 du 29. juin 1984.

22. Code du Domaine public fluvial et de la navigation interieure.

#### IV. THE RESPONSIBILITY OF FARMERS

##### A. *Penalties*

A farmer who violates the public's right of access, may commit a criminal offense. Under Norwegian and Swedish law, a farmer risks a fine if he violates the "Allemannsrett" by fencing an area open to the public.<sup>23</sup>

##### B. *Removal of Obstructions*

If the farmer obstructs the passage of a road to which the public has a right of access, people may ignore the obstruction if possible. They may also remove the obstruction if it can be done without harm to the property. Otherwise, the only remedy is complaining to the proper administrative agencies which can take the steps necessary to get the obstacle removed.

Obstruction of a highway seems to be a problem in England and Wales where the plowing and cropping of smaller highways often occurs. Twenty-six percent of the length of all footpaths in England and Wales are said to be out of use due to plowing or obstructions of various kinds. However, the law permits the farmer to plow a footpath or bridleway if it is in accordance with good husbandry to do so together with the surrounding field.<sup>24</sup> Generally, the path must be restored within fourteen days although sometimes as little as twenty-four hours is given for restoration.<sup>25</sup>

##### C. *Liability*

If a member of the public is injured from his passage on private farmland, the farmer may be liable.

1. *Scandinavia*.—Under Scandinavian law, the landowner may be liable according to the so called "rule of culpa." The rule of culpa is a "judge-made law" according to which a person must pay damages if he intentionally or negligently causes a pecuniary loss to another (provided the negligent party has violated an interest that the law intends to protect).

The question is, of course, what the law understands by "reasonable care." There are very few court decisions in this area, but the landowner has a special duty to protect people that he has permitted to enter his land, such as hunters and fishermen.

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23. See, e.g., § 40 in the Norwegian lov af 28. juni 1957 om friluftslivet.

24. Right of Access Act (1990).

25. Highway Act (1980), modified by Right of Way Act (1990).

The farmer also has some duties to trespassers. If he actually knows that people have entered his land, he must warn them if he realizes that they are likely to be injured from animals, hunting, or felling of trees. If he knows that trespassers often use part of his land, such as for a short cut from a bus station to their homes, he must take care that they are not harmed from the felling of trees, excavation, and so forth.

As mentioned above, the Danish Nature Conservation Act gives the public a statutory right to walk across uncultivated areas and to use forest roads on foot.<sup>26</sup> According to this statute, people enter the land at their own risk. Nevertheless, even if the act is silent on this point, it is safe to assume that the landowner must warn the public against special dangers. If the landowner makes special arrangements for the public, such as for a toboggan run or a jogging path, he also has a special duty to take care that they do not present any risk to people who use them.

2. *England and Wales*.—Originally, common law in England and Wales distinguished between invitees, licensees, and trespassers. American law adopted these distinctions. The common law rule in England and Wales has been supplanted by the Occupiers Liability Acts 1957 and 1984.<sup>27</sup>

The courts found it difficult to place people into one of the three categories. So the 1957 Act puts invitees and licensees in one category called visitors. This group includes anyone the occupier has given an invitation or permission to use his land. The statute does not cover public or private rights of way. Travelers must take the road as they find it.

The occupier owes a visitor the duty to take such care as is necessary to see that the visitor is reasonably safe in using the premises for the purpose for which he is invited or permitted to be on the land.

The 1957 Act does not include the third category found in the common law: the trespassers. According to the common law rule, the landowner generally was not liable for damages suffered by trespassers. That rule was found to be too harsh. The common law rule was supplanted by the Occupiers Liability Act 1984.<sup>28</sup> According to this statute, the occupier may be liable to pay damages to trespassers who suffer injury on his premises by reason of any danger "due to the state of premises or to things done or omitted to be done to them."<sup>29</sup>

For the occupier to be liable, the statute requires that he must be aware of the danger or have reasonable grounds to believe that it exists.

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26. *See supra* note 3 and accompanying text.

27. Occupiers Liability Acts (1957 & 1984).

28. Occupiers Liability Act (1984).

29. *Id.*

He must also know or have reasonable grounds to believe that the trespasser is in the vicinity of the danger. Finally, the risk must be one for which the occupier may reasonably be expected to offer the trespasser some sort of protection. The author of this Article has been unable to obtain information on court decisions regarding to the Occupiers' Liability Acts 1957 and 1984; however, they seem very close to the *culpa* rule of Scandinavian law.

3. *France*.—Under French law, there is no special legislation on the owner's liability. According to Code Civil Article 1382 and 1383, a person is liable for damages if he causes a loss to somebody by "faute," either intentionally or negligently. According to Article 1384, an owner must pay damages for losses inflicted by "things," including real property, in his care. This is a rule of strict liability. A landowner probably would be liable according to Article 1384 if someone on his land is hit by a falling tree or hurt by an electric installation which through no fault of his own is out of order. If the damage is done by domestic animals, such as a roaming bull, the owner is responsible according to a rule of strict liability in Article 1385.

These rules apply also to the landowner's liability for injury suffered from persons on his premises. However, with respect to trespassers, damages might be reduced because a trespasser may be said, to a certain extent, to have created his own injury.

## V. THE LIABILITY OF THE PUBLIC

Evidently, members of the public have some duties to the farmer whose land is entered. Those duties might be stated in a very detailed manner in statutes, ministerial orders, bylaws of nature reserves, or contracts between a farmer and hunters, fishermen, or others whom he has permitted to enter his land.

If members of the public breach these duties, they are liable for damages — in England and Wales usually according to the law of torts, in Scandinavia according to the law of *culpa*, and in France according to Code Civil Article 1382 and Article 1383. In all countries there is a legislation on strict liability for damages caused by dogs.

Violation of the public's duties to the landowner might also be a criminal offense. Arson, poaching, wanton destruction of property and stealing crops, fruits, lumber, and the like are crimes anywhere.

Picking flowers for personal use and picking berries or mushrooms for consumption on the spot or for noncommercial purposes is usually not an offence unless the owner forbids it. Still, this has caused conflicts between landowners and visitors in all countries, for instance in Languedoc-Roussillion and other parts of France where people often collect mushrooms, chestnuts, and snails thereby depriving the landowners of an income.

Trespass to land is a criminal offense under Scandinavian Law, but not under English Law where it is only a tort that entitles the occupier to damages. The landowner may obtain an injunction against trespassing from the court. He may even eject the trespasser using such force as is reasonably necessary.

## VI. MEANS OF PROVIDING ACCESS FOR THE PUBLIC

In Europe, as in the United States, the problems of public access to the countryside are becoming more and more acute. The demand for public access started in the last century. In England, this demand can be traced to the early 1820s.<sup>30</sup> At first, only a few people were interested. However, when industrialization began and the population moved from the countryside to the towns, more people felt the need to escape from the dullness and squalor of cities and factories, and to spend their spare time in the countryside.

In the twentieth century, working people received higher salaries and longer holidays, and the interest in sports increased. The number of recreationists grew, as did the conflicts between the sports enthusiasts and the farmers and landowners. This was the case even in Norway and Sweden. Landowners feared, sometimes with good cause, the effects of increasing public access to their land.

The problem of recreation in the countryside might have been considered a private matter between recreationists and landowners. However, recreationists created powerful organizations to protect their interests and to act as political pressure groups. Governments in all five countries made it public policy to encourage and promote recreation and sport and to provide access to the countryside for every member of the community, not only for special user groups or high income groups who can afford to pay for access. That also has been the view of the Council of Europe and the Scandinavian Council.<sup>31</sup>

Which mechanisms have been employed to accomplish their goal? Consider the responses of England, Wales, Denmark and France.

### A. *Compulsory Measures*

Generally, compulsory measures are rarely used in England, Wales, and France, while they are more common in Denmark.

1. *Statutory Rights of Access*.—According to the Danish Constitution of 1953, the taking of property for public use entitles the owner

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30. ACCESS STUDY, *supra* note 8, at 9.

31. Council of Europe, European Sport for All Charter, Resolution (76)41, Sept., Council of Europe 1976 and Friluftsliv i Norden, Nordisk Ministerrads sekretariat i Oslo, 1982.

to full compensation. However, when a whole category of land, such as beaches or forests, is submitted by a statute to certain restrictions, it is usually not considered a "taking" under Scandinavian law. The landowner has no constitutional right to compensation for the loss caused by the statute.

Many countries have used this type of mechanism. In Denmark, statutes on nature conservation opened the beaches for public access in 1935, 1937, and 1969. Similarly, in 1969 uncultivated areas and roads in forests above five hectares were opened to the public.

When the Danish Nature Conservation Act was passed in 1969, some landowners sued the government for compensation according to the provisions of the Constitution. However, the courts upheld the statute as a general regulation of property rights not protected by the Constitution.<sup>32</sup>

The opening of the forests, however, which to a large extent are situated on private farms, was done without the necessary negotiations with the owners. For some time, relations between the owners and the authorities were strained.

In 1989, the government proposed a new statute to open roads and paths on farmland for the public. A farmer will only have the right to close a road if he thinks that access will cause a nuisance, and a local authority can order him to open the road again if there is not a sufficient reason to close it. This time the bill has been negotiated with the landowners. The farmers' unions seem inclined to accept the bill while recreationists perhaps feel that the bill is too weak.<sup>33</sup>

2. *Rights of Access Created by the Decision of an Administrative Agency.*—Administrative agencies may be empowered to submit a particular area to an easement, thereby giving the public a right of way over the land. The agencies may even have the power to order a farmer to cede a piece of his land to public authorities for the creation of a camping site or a parking lot.

In England and Wales, statutes empower local planning authorities to issue access orders to ensure public access to private land for open-air recreation when an agreement with the owners is impractical or inadequate.<sup>34</sup> Their decision is subject to the secretary of state's approval. As a general rule, access orders cannot include cultivated land. Access orders seldom have been used due to the reluctance of local authorities to resort to compulsory powers to protect recreational uses.<sup>35</sup>

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32. UGESKRIFT FOR RETSVAESEN (DANISH L. REV.) 1972 p. 189, 1972 p. 192 and 1972 p. 603 (1971 p. 666).

33. Forslag til lov om naturbeskyttelse (Folketingstidende 1990/91 Tillaeg A).

34. National Parks and Access to the Countryside Act (1949), Countryside Act (1968).

35. ACCESS STUDY, *supra* note 8, at 76, 109.

In Denmark, local nature conservation boards have the power to create public rights of way over private land and even to acquire land against the will of the landowner for recreational purposes. Under Danish law that is a "taking" which gives the landowners the right to full compensation.<sup>36</sup> This mechanism is often used because agreements with farmers may be difficult to obtain, and a whole network of footpaths might be useless if just one farmer refuses to allow a path on his land.

According to a new statute of 1989, the Danish Government, and county and municipal councils are empowered to acquire land by eminent domain when it is necessary to improve the local population's opportunities for recreation and sport.<sup>37</sup>

In France, the authorities have the power to create public rights of way by means of eminent domain, but this rarely happens.<sup>38</sup> The county also has the power to acquire land by eminent domain for recreational purposes according to the Urban Planning Act.<sup>39</sup> Compensation is paid with the help of the "green tax," which is discussed below.

### *B. Voluntary Arrangements*

The best way to increase public access to the countryside is to obtain the consent of the farmers and landowners. In all of the five countries discussed, recreational and sporting organizations purchase or lease land for scouts' cabins, golf courses, and camping sites, or they purchase or lease shooting and fishing rights. In Denmark, according to the Nature Conservation Act of 1969 and the Nature Management Act 1989, public authorities may purchase land in the open market to create public parks and picnic and recreational areas. However, the success of this instrument depends on the budget of the authorities. Experience has shown that the budget is often reduced in times of crisis.

In England and Wales, the statutes empower local authorities to enter access agreements — legal agreements with farmers and other landowners — in order to secure public recreational access to their land. The access agreements have been used to some extent, but they do not include cultivated farmland.

The local authorities also have the power to enter management agreements with farmers.<sup>40</sup> The management agreements contain restrictions on the methods of cultivation of the land and its use for agricultural purposes. These agreements, above all, serve nature conservation, but they may also ensure public access to the area in question.

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36. Nature Conservation Acts (1917, 1937 and 1969).

37. Lov nr. 339 af 24.5.1989 om naturfarvaltning.

38. Loi no. 85-30 du 9, janvier 1985 art 53, 54.

39. Code de l'urbanisme. L 142-2, L 142-5.

40. The Wildlife and Countryside Act (1981).

In France, the counties are empowered to enter into contracts with private landowners about opening private roads to the public. Contracts with farmers typically are extended for one year only. Considering the short duration of the contracts, the farmers of Languedoc-Roussillon do not seem to mind renewing them year after year.

The county may also pay a landowner to create an easement giving the public a permanent right to use a road over his land. The landowner is paid from the "green tax."

Each county has produced a county map (plan départemental) showing all roads and paths in the county that are open to the public. The map shows the ordinary public roads (voies publiques), county roads (chemins ruraux), and private roads and paths open for public access according to a contract between the owner and the county council.<sup>41</sup>

The French Urban Planning Act empowers the county to levy a special tax called the green tax (la taxe des espaces naturels sensibles) on building activities in order to obtain money for nature conservation and recreation. With this money, the county can buy land for recreational purposes in special zones. The county may use a right of preemption, but usually it acquires the land in the free market. In Languedoc-Roussillon, the green tax is used in a great number of municipalities.

### C. Financial Incentives<sup>42</sup>

England has attempted exemption from taxation under the provisions of the Finance Acts 1975 and 1976.<sup>43</sup> However, the exemption has only applied to national heritage land of the highest quality, not ordinary farmland.

In France, income from agricultural activities is taxed at a lower rate than income from other commercial activities. Up to a certain point, a farmer's income derived from operating or creating a camping site or a country inn is considered agricultural activity income and not commercial income.

In France, the county also pays subsidies to farmers who wish to create a camping site or a country inn. As a rule, the county pays twenty-five percent of the expenses within a certain maximum, depending on whether the farm is situated in a wine growing region, in the mountains, or in zones classified as "less favoured areas."

In Languedoc-Roussillon, groups of farmers can obtain aids for the same purposes from special programs that the European Communities

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41. Loi no. 83-663 due 22. juillet 1983 art. 56, circ. 30. aout 1988 (J.O. 10. dec.).

42. The information on French Law in this section is received during an interview in the county council of Hérault, Languedoc-Roussillon.

43. ACCESS STUDY, *supra* note 8, at 77.

have created to help farmers in Southern Europe (Programmes Intégrés Méditerranéens). Usually, thirty percent of the expenses are covered up to a maximum of thirty-five thousand francs.

When the roads in the forests of Denmark were opened to the public in 1969, the Ministry for the Environment and the Danish Forestry Union entered an agreement according to which the government would insure against damage from fire, theft, and destruction of property caused by visitors. The agreement covers damage to plants and trees, buildings, machines, and instruments used for forest management. This arrangement has cost the taxpayers very little, and it has done much to restore good relations between the landowners and public authorities.

#### *D. Limitations of the Farmer's Liability*

Farmers, especially farmers near urban areas, are often worried about their liability for injury to visitors on their land. In America, several states have tried to solve this problem through recreational use statutes according to which owners who open their land to the general public for recreational purposes without charge are not liable for injuries the users suffer due to the condition of the premises.<sup>44</sup> In England, landowners have a right to exclude liability except when the landowner's business is to provide recreation and sport for the public.<sup>45</sup> Similar legislation does not exist in Denmark or in France.

#### *E. Education of Visitors*

Many landowners are reluctant to open their land for public access because of the ignorance of visitors who, without realizing it, might cause significant damage by trampling down crops, lighting fires in dry plantations, and "dog-worrying" of sheep. However, governments, local authorities, and organizations are aware that increasing public access should be accompanied by an understanding of the farmers' problems. Schools, organizations, local councils, and government agencies (including the English Countryside Commission) try to educate the urban population and teach the public how to behave in the countryside.

### VII. FINAL REMARKS

In Europe, the demand from the urban population for recreational access to the countryside has increased dramatically, especially since the

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44. Becker, *Legal Liability Associated with Profitable Resource-Based Recreation on Private Land Legal Issues*, National Center for Agricultural Law Research and Information, School of Law, University of Arkansas, Fayetteville.

45. Occupiers Liability Act (1984).

last World War. Quite naturally, there is a widespread suspicion among landowners and farmers concerning the whole issue of increasing public access to their premises. However, private organizations and sport clubs often attempt to buy or lease land or purchase hunting and fishing rights.

More importantly it has become government policy to try to meet the demand for access to the open country and to make sure that all groups have the opportunity to use the countryside for recreation and sport. Governments use a whole range of instruments to carry out this policy. Voluntary solutions such as the purchase of land in the open market and access agreements combined with financial incentives are usually preferred. Sometimes it is considered necessary to use compulsory measures, including eminent domain. This is especially true in Denmark where there are very few recreational areas.

In all countries, administrative agencies and private organizations try to teach visitors about the problems of the rural population. Experience from Norway and Sweden shows that public access to the countryside need not influence farm production or disturb the peace of the countryside.



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## NOTE

### Corporate Ownership Restrictions and the United States Constitution

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#### I. INTRODUCTION

Many states have adopted measures restricting corporate ownership of farm lands. The restrictions vary from limitations on foreign corporate ownership of farmlands to the prohibition of farmland ownership by any nonfamily corporation. All states adopting such measures have done so statutorily, except Nebraska, which has done so via a state constitutional amendment.<sup>1</sup> This Article will discuss the constitutionality of such restrictions, focusing on equal protection and commerce clause analyses. The Nebraska constitutional amendment will be examined extensively.<sup>2</sup>

Typically, such measures are adopted in an effort to preserve the "family farm" by making it difficult for nonfamily corporations to gain any type of monopoly power in agriculture. A common explanation for this protectionism is the special place family farms hold in so many people's lives. Many people feel that they have some farm ties even

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1. IOWA CODE ANN. §§ 172C.1-.15 (West Supp. 1989); KAN. STAT. ANN. §§ 17-5901 to -5904 (1988); MINN. STAT. ANN. § 500.24 (West 1990); MO. ANN. STAT. § 350.015 (Vernon Supp. 1990); N.D. CENT. CODE §§ 10-06-01 to -15 (1985 & Supp. 1989); OKLA. STAT. ANN. tit. 18, § 951-56 (West 1986 & Supp. 1990); S.D. CODIFIED LAWS ANN. §§ 47-9A-1 to -23 (1983 & Supp. 1989); WIS. STAT. ANN. § 182.001 (West Supp. 1989).

2. This Article will focus on the Nebraska amendment rather than a typical statute because the Nebraska amendment is structurally and functionally similar to the typical corporate ownership restriction statute and because the Nebraska Supreme Court is one of the few courts to have ruled on the federal constitutionality of such a measure. See NEB. CONST. art. XII, § 8.

though only a small minority of Americans are currently farmers.<sup>3</sup> What was once a nation of farmers is now a nation of urban dwellers who came from farmers at some point in their past.

Restrictions on corporate ownership of farmlands are not new. In the early twentieth century, a Mississippi statute prohibited corporate ownership of farmland, but the Mississippi Supreme Court mentioned no constitutional infirmity when discussing the application of this statute in *Middleton v. Georgetown Mercantile Co.*<sup>4</sup>

Other states did not go so far as to ban corporate ownership of farmlands. Instead, lesser restrictions on corporate ownership of farmlands became a common method of dealing with the perceived need to protect family farms. For example, Oklahoma limited corporate ownership of farmlands to corporations that were strictly farming corporations.<sup>5</sup>

Today, several states regulate corporate ownership of farmlands: Iowa, Kansas, Minnesota, Missouri, North Dakota, Oklahoma, South Dakota, and Wisconsin have statutes that restrict or prohibit corporate ownership of farmlands.<sup>6</sup> In 1982, Nebraska adopted a constitutional amendment barring corporate ownership of farmland.<sup>7</sup> Before a constitutional examination of such measures may be undertaken, the following background information must be discussed.

## II. DISCUSSION

### A. Due Process

The due process clause of the fourteenth amendment to the United States Constitution mandates that no state shall "deprive any person of life, liberty, or property, without due process of law . . . ."<sup>8</sup> Businesspersons have made due process challenges, claiming a loss of property and liberty rights, when the state has impeded business operations through restrictive or regulatory action, but such challenges generally have not

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3. In 1969, the farm population of the United States was roughly 1/3 of what it was in 1935. U.S. DEPT. OF COMM., BUR. OF THE CENSUS, HISTORICAL STATISTICS OF THE U.S.: COLONIAL TIMES TO 1970, pt. 1, at 458. The farm population has continued to decrease since 1969. U.S. DEPT. OF COMM., BUR. OF THE CENSUS, 1987 CENSUS OF AG., U.S. DATA, vol. 1, pt. 51, table 1, at 1.

4. 117 Miss. 134, 77 So. 956 (1918). The court simply held that only the *state* could challenge corporate ownership of farmland under the statute.

5. See *LeForce v. Bullard*, 454 P.2d 297 (Okla. 1969); *Texas Co. v. State ex rel Coryell*, 198 Okla. 565, 180 P.2d 631 (1947).

6. See statutes cited *supra* note 1.

7. NEB. CONST. art. XII, § 8.

8. U.S. CONST. amend. XIV, § 1.

been successful. In *Nebbia v. People of State of New York*,<sup>9</sup> a grocer was charged under a statute that fixed the retail price of milk. In upholding the statute and dismissing the grocer's due process argument, the United States Supreme Court stated: "The Constitution does not guarantee the unrestricted privilege to engage in a business or to conduct it as one pleases. Certain kinds of business may be prohibited; and the right to conduct a business, or to pursue a calling, may be conditioned."<sup>10</sup>

The Court considers a corporation to be a citizen within the due process and equal protection clauses of the Constitution.<sup>11</sup> Thus, a corporation may bring a due process challenge against legislation. However, the due process clause was not offended by North Dakota's statute restricting corporate ownership of farmland (the statute also required lands currently owned by corporations to be disposed of within ten years).<sup>12</sup> In *Asbury Hospital v. Cass County, North Dakota*,<sup>13</sup> the Court upheld the statute despite due process and equal protection challenges. Regarding due process, the Court stated that "[t]he Fourteenth Amendment does not deny to the state power to exclude a . . . corporation from doing business or holding property within it."<sup>14</sup> Therefore, due process is not violated by a state's "unqualified power . . . to preclude [a corporation's] entry into the state" to engage in farming.<sup>15</sup>

The Court in *Nebbia* was not receptive to due process challenges to local economic regulations:

So far as the requirement of due process is concerned, and in the absence of other constitutional restriction, *a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose*. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose, and are neither arbitrary

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9. 291 U.S. 502 (1934).

10. *Id.* at 527-28 (footnotes omitted).

11. *Grosjean v. American Press Co.*, 297 U.S. 233, 244 (1936).

12. 1933 N.D. Laws 494, 495 (as amended by Chap. 89, Laws 1933, and Chap. 111, Laws 1935).

13. 326 U.S. 207 (1945).

14. *Id.* at 211 (citations omitted).

15. *Id.* Apparently, the state is not required to provide a reason for the exclusion: "Legislation excluding . . . a corporation from continuing [operations] in the state has been sustained as an exercise of the general power to exclude foreign corporations which does not offend due process." *Id.* at 212. No reason was given for the exclusion in this case.

nor discriminatory, the requirements of due process are satisfied . . . .<sup>16</sup>

This statement seems to reflect the Court's desire to steer economic challenges away from the due process clause. This deference to local legislative decisions regarding economic matters continues to be the Court's method of analyzing such suits brought on due process grounds.<sup>17</sup> Therefore, a corporation must look beyond the due process clause to make a successful attack on corporate ownership restrictions.

### *B. Equal Protection*

The equal protection clause of the fourteenth amendment<sup>18</sup> is a better vehicle for pursuing a challenge to corporate restriction of farm ownership. By its very nature, such a restriction treats one class of persons<sup>19</sup> differently than other classes, which is the essence of an equal protection challenge.

Equal protection cases are reviewed under three tiers of scrutiny, depending upon the nature of the subject class.<sup>20</sup> At the highest level of scrutiny is the suspect class. A suspect class involves the classification of a group that has historically been the victim of discrimination, such as a classification based upon race.<sup>21</sup> Under the strict scrutiny applied to a suspect class, the statute will be upheld only if it is found to be necessary to the attainment of some compelling governmental objective.<sup>22</sup>

The middle tier of scrutiny is typically applied to gender-based classifications.<sup>23</sup> A gender-based classification will be upheld only when the classification serves important governmental objectives and is substantially related to the achievement of those objectives.<sup>24</sup>

The lowest tier of scrutiny is reserved for classes created and affected by most economic and social welfare legislation — those cases not involving suspect classes or gender-based classes.<sup>25</sup> Under this level of scrutiny, the classification will be upheld when the means chosen by the

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16. *Nebbia*, 291 U.S. at 537 (emphasis added).

17. See, e.g., *North Dakota St. Bd. of Pharmacy v. Snyder's Drug Store*, 414 U.S. 156 (1973).

18. U.S. CONST. amend. XIV, § 1: "No State shall . . . deny to any person within its jurisdiction the equal protection of the laws."

19. A corporation is a "person" for equal protection purposes. See *supra* note 11.

20. *Michael M. v. Superior Ct. of Sonoma Co.*, 450 U.S. 464, 468-69 (1981).

21. See, e.g., *Bolling v. Sharpe*, 347 U.S. 497 (1954).

22. See, e.g., *University of Cal. Regents v. Bakke*, 438 U.S. 265 (1978).

23. See, e.g., *Michael M.*, 450 U.S. 464.

24. *Id.*

25. See, e.g., *Vance v. Bradley*, 440 U.S. 93 (1979).

legislature bears a rational relationship to a legitimate legislative purpose.<sup>26</sup> Restrictions on corporate ownership of farmland would be reviewed under this low level of scrutiny.<sup>27</sup>

The cases utilizing this low level of scrutiny indicate the deference the Court gives the legislative branch. In *Vance v. Bradley*,<sup>28</sup> the Court's reluctance to act is demonstrated by the following language:

The Constitution presumes that . . . even improvident decisions will eventually be rectified by the democratic process and that judicial intervention is generally unwarranted no matter how unwise we may think a political branch has acted. Thus, *we will not overturn such a statute unless the varying treatment of different groups or persons is so unrelated to the achievement of any combination of legitimate purposes that we can only conclude that the legislature's actions were irrational.*<sup>29</sup>

In *Vance*, the Court had to decide "whether Congress violate[d] the equal protection [clause] . . . by requiring retirement at age 60 of federal employees covered by the Foreign Service retirement and disability system but not those covered by the Civil Service retirement and disability system."<sup>30</sup> The complainant's argument was that the Foreign Service's mandatory retirement age discriminated on the basis of job classification. Using this test, the Court sustained the retirement age.<sup>31</sup>

The government cited the goal of maintaining

the professional competence, as well as the mental and physical reliability, of the corps of public servants who hold positions critical to our foreign relations, who more often than not serve overseas, frequently under difficult and demanding conditions, and who must be ready for such assignments at any time.<sup>32</sup>

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26. *Id.* at 97. While the "magic words" articulating this test are virtually identical to the due process test mentioned earlier, the tests involve different regulatory schemes. In the typical due process case, the complainant alleges that state action has deprived it of a property or liberty interest without affording it due process of law. In the typical equal protection case, the challenge is to a statutory scheme treating one statutorily created class differently from other allegedly similar classes. There is still little difference between the two tests — both grant much deference to the state. However, language in equal protection cases indicates that the Court is more willing to entertain challenges to economic regulations based on equal protection rather than on due process grounds.

27. See, e.g., *Asbury Hosp. v. Cass County*, N.D., 326 U.S. 207 (1945).

28. 440 U.S. 93 (1979).

29. *Id.* at 97 (emphasis added).

30. *Id.* at 94-95.

31. *Id.* at 112.

32. *Id.* at 97.

The Foreign Service officers challenging the retirement age in *Vance* did not question the legitimacy of this goal.<sup>33</sup> The dispute centered on whether the retirement age was rationally related to this purpose.

The Foreign Service claimed that the retirement age fostered superior achievement through the assurance of a reasonable "pyramid of promotion"<sup>34</sup> and that younger persons could more easily handle the rigors of overseas duties.<sup>35</sup> The Court held that the duty to disprove those claims rested with the complainants, and that this burden had not been met: "In an equal protection case of this type [a statutory classification], . . . those challenging the legislative judgment must convince the court that the legislative facts on which the classification is apparently based could not reasonably be conceived to be true by the governmental decisionmaker."<sup>36</sup> The complainants did admit that the basis of the classification was arguable. Having failed to prove that Congress had no reasonable basis for creating the classification, the statute was upheld.<sup>37</sup>

In *Minnesota v. Clover Leaf Creamery*,<sup>38</sup> the Court held that the burden is the same regarding a challenge to a state statutory classification:

States are not required to convince the courts of the correctness of their legislative judgments. Rather, "those challenging the legislative judgment must convince the court that the legislative facts on which the classification is apparently based could not reasonably be conceived to be true by the governmental decisionmaker."<sup>39</sup>

In *Clover Leaf*, the Court upheld a Minnesota statute that banned the retail sale of milk in plastic nonreturnable containers but permitted milk to be sold in other nonreturnable containers.<sup>40</sup>

*Vance* and *Clover Leaf* demonstrate that a party challenging restrictive farm ownership legislation on equal protection grounds must overcome the presumption of validity by clearly showing that the re-

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33. *Id.*

34. *Id.* at 100-01.

35. *Id.* at 103.

36. *Id.* at 111 (citations omitted).

37. The Court stated: "[I]t is the very admission that the facts are arguable that immunizes from constitutional attack the congressional judgment represented by this statute." *Id.* at 112.

38. 449 U.S. 456 (1981).

39. *Id.* at 464.

40. *Id.* at 458, 474. Both types of containers admittedly caused environmental problems. However, the Court held that Minnesota's stated purpose, to encourage development of returnable and reusable packaging, was reasonably fostered by a ban on plastic containers (which were the more popular of the two types of containers). *Id.* at 470-74.

striction is irrational. As mentioned above, the Court decided in *Asbury Hospital* that such restrictive legislation is valid (under equal protection analysis).<sup>41</sup> *Asbury Hospital* further demonstrates that an equal protection challenge to such legislation, when the complainant offers no proof of irrationality, is almost impossible: "Statutory discrimination between classes which are in fact different *must* be presumed to be relevant to a permissible legislative purpose, and will not be deemed to be a denial of equal protection *if any state of facts could be conceived which would support it.*"<sup>42</sup> If the challenging party produced no evidence showing the irrationality of the measure, a court faced solely with an equal protection challenge to a statutory corporate farming restriction could uphold the statute by simply relying on the state's claim that such a restriction is rationally related to the desire to protect the family farm from being swallowed up by large corporate farm organizations.

However, if the challenging party is able to show that the reason given is not factually supported, that party would have a chance to overturn the legislation. For example, if a party were able to show that the purpose of restrictive legislation was to protect family farms, and if that party were further able to demonstrate that nonfamily corporations were not a threat to family farms, the legislation might be deemed irrationally based, and therefore contrary to the equal protection clause.

The abstractness of the perceived corporate threat makes this a risky undertaking at best. However, unlike the due process challenges to such legislation, success seems possible under this approach. The sentimentality associated with people's views of family farms certainly is an aid that should be utilized when making such a challenge. A demonstration that sentimentality was the basis of the decision to restrict corporate ownership, as opposed to actual data demonstrating that corporations pose a threat to family farms, could create a suspicion that would persuade a court to give the case serious consideration. Once that was done, given the burden placed on the challenging party by *Asbury Hospital* and the subsequent line of cases,<sup>43</sup> the challengers must present uncontradicted evidence that corporations do not pose a threat to family farms.<sup>44</sup> This process is discussed below after the Nebraska case that has arisen from Nebraska's corporate ownership ban.

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41. See *Asbury Hosp. v. Cass County*, N.D., 326 U.S. 207 (1945).

42. *Id.* at 215 (emphasis added). Inevitably, the state will enumerate facts to support such challenged legislation during a court battle.

43. E.g., *Minnesota v. Clover Leaf Creamery*, 449 U.S. 456 (1981); *Vance v. Bradley*, 440 U.S. 93 (1979).

44. No such showing was attempted by the complainant in *Asbury Hospital*. The corporation merely claimed that its constitutional rights were violated when North Dakota took away its ability to hold agricultural land, a right it had exercised prior to the statute. *Asbury Hospital*, 325 U.S. at 209-10.

It is conceivable that a challenging party could prevail under an equal protection theory, although the extreme burden required of the challenging party would make a favorable outcome doubtful. However, the chances of success seem greater than those available to the party who challenges corporate restrictions on due process grounds. Supreme Court decisions indicate that a commerce clause challenge might be a more successful way to attack restrictions on corporate ownership of farmland than either due process or equal protection challenges.

### *C. Commerce Clause*

“The Congress shall have power . . . To regulate Commerce with foreign Nations, and among the several States . . .”<sup>45</sup> This delegation of power has proven to be one of the most powerful clauses in the Constitution. The cases interpreting Congress’s power regarding commerce are far-reaching.<sup>46</sup> Two circumstances exist that call for interpretation of the commerce clause in response to legislative action: (1) situations in which Congress has acted directly to regulate commerce,<sup>47</sup> and (2) situations in which Congress has not acted on a matter regarding commerce but a state has acted (commonly referred to as dormant commerce clause cases).<sup>48</sup> The first class of cases is relevant to this discussion because it articulates the scope of Congress’s ability to regulate commerce. These cases indicate that agricultural matters come within the purview of the commerce clause, and therefore may be regulated by Congress.<sup>49</sup> The dormant commerce clause cases are directly applicable to this discussion because any commerce clause challenge to state corporate ownership restrictions would be made under dormant commerce clause principles given the current state of congressional abstinence from the field.<sup>50</sup> When a state, as opposed to Congress, regulates commerce, dormant commerce clause principles govern.

Early in the judicial history of the United States, the scope of the commerce clause was addressed.<sup>51</sup> The early debate centered on whether Congress had the exclusive right to regulate interstate commerce or merely a right superior to the states’ rights to regulate commerce.<sup>52</sup>

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45. U.S. CONST. art. I, § 8.

46. *E.g.*, *Raymond Motor Transp., Inc. v. Rice*, 434 U.S. 429 (1978); *Southern Pac. Co. v. Arizona*, 325 U.S. 761 (1945); *Wickard v. Filburn*, 317 U.S. 111 (1942); *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1.

47. *See, e.g.*, *Wickard v. Filburn*, 317 U.S. 111 (1942).

48. *See, e.g.*, *Willson v. Black Bird Creek Marsh Co.*, 27 U.S. (2 Pet.) 244.

49. *See, e.g.*, *Wickard*, 317 U.S. 111.

50. *Willson*, 27 U.S. (2 Pet.) 244.

51. *See, e.g.*, *Willson*, 27 U.S. (2 Pet.) 244; *Gibbons v. Ogden*, 22 U.S. (9 Wheat.)

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52. *See, e.g.*, *Willson*, 27 U.S. (2 Pet.) 244; *Gibbons v. Ogden*, 22 U.S. (9 Wheat.)

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The first case to present the question to the Supreme Court was *Gibbons v. Ogden*,<sup>53</sup> which involved New York's refusal to recognize Gibbons's federal steamboat operator's license because New York had granted Ogden the exclusive right to operate a steam vessel in New York waters. The case was decided on grounds of federal supremacy.<sup>54</sup> Chief Justice Marshall, in invalidating the New York law, avoided the question of the extent of a state's commerce regulating powers when there is congressional silence by finding a congressional mandate on the issue.<sup>55</sup> However, Chief Justice Marshall indicated a willingness to embrace a concept of federal exclusivity regarding the commerce power.<sup>56</sup> Under such a view of the commerce clause, the federal government would have exclusive control over interstate commerce, and the states would be powerless to take action affecting interstate commerce even when no congressional action had been taken. However, this view of federal exclusivity was never adopted by the Court. Such a view was expressly rejected in *Willson v. Black Bird Creek Marsh Company*,<sup>57</sup> in which the Court held that a state could regulate commerce in the face of congressional silence.<sup>58</sup> Therefore, by 1829, the two classes of commerce cases had been delineated.

Cases involving federal statutes demonstrate that even farming regulations that deal with purely local matters fall within the scope of the commerce clause. For example, the Court in *Wickard v. Filburn*<sup>59</sup> allowed Congress to regulate the amount of crops grown by a farmer, even if grown for purely local consumption rather than for placement in the stream of interstate commerce. The *Wickard* Court reasoned that if purely local matters are part of an entire class of acts that has a substantial effect on interstate commerce, Congress may regulate the entire class.<sup>60</sup> It is undisputed that the production of agricultural products is inextricably entwined with interstate commerce. Although restrictions on corporate ownership of farmlands are arguably a local concern, the *Wickard* test indicates that production of agricultural products is part of an entire class of acts that has a substantial effect on interstate commerce. Although restrictions on farmland ownership could affect the production of agricultural products, the federal government has not acted to restrict

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53. 22 U.S. (9 Wheat.) 1.

54. *Id.* at 210.

55. *Id.*

56. *Id.* at 209.

57. 27 U.S. (2 Pet.) 244.

58. *Id.* at 252.

59. 317 U.S. 111 (1942).

60. *Id.* at 129.

ownership of farmlands. Therefore, the validity of state restrictions on farm ownership falls within the scope of dormant commerce clause principles.

The cases involving the dormant commerce clause typically involve a balancing of local interests (those allegedly fostered by the state statute) against the national interest in preserving free flowing interstate commerce.<sup>61</sup> This balancing approach is best explained in *Southern Pacific Co. v. State of Arizona*.<sup>62</sup> In invalidating Arizona's restriction of train lengths, the Court stated:

Although the commerce clause conferred on the national government power to regulate commerce, its possession of the power does not exclude all state power of regulation. Ever since *Willson v. Black Bird Creek Marsh Co.* . . . and *Cooley v. Board of Wardens* . . . , it has been recognized that, in the absence of conflicting legislation by Congress, there is a residuum of power in the state to make laws *governing matters of local concern* which nevertheless in some measure affect interstate commerce or even, to some extent, regulate it . . . . When the regulation of matters of local concern is local in character and effect, and *its impact on the national commerce does not seriously interfere with its operation*, and the consequent incentive to deal with them nationally is slight, such regulation has been generally held to be within state authority.<sup>63</sup>

*Southern Pacific* further emphasizes the balancing test required:

The decisive question is whether *in the circumstances* the total effect of the law [regarding its purpose] *is so slight* or problematical as not to outweigh the national interest in keeping interstate commerce free from interferences which seriously impede it and subject it to local regulation which does not have a uniform effect . . . .<sup>64</sup>

The Court held that Arizona's statutory effort to improve railway safety was completely ineffective, and that it therefore did not "outweigh the national interest in keeping interstate commerce free from interferences."<sup>65</sup>

In *Southern Pacific*, the challenging party was able to present uncontradicted evidence that safety would not be enhanced by the contested

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61. See, e.g., *Southern Pac. Co. v. Arizona*, 325 U.S. 761 (1945).

62. 325 U.S. 761 (1945).

63. *Id.* at 766-67 (emphasis added) (citations omitted).

64. *Id.* at 776 (emphasis added).

65. *Id.* at 775-76.

measure.<sup>66</sup> A state highway regulation affecting truck-trailer lengths was similarly overruled in *Raymond Motor Transport, Inc. v. Rice*.<sup>67</sup> The rule from *Southern Pacific* and its progeny is that when there is a strong national interest in interstate commerce, coupled with evidence that the promoted local concern affecting interstate commerce will not be served by the contested local measure, the local statute will be invalidated. This rule also applies to corporate ownership restrictions.

A case concerning corporate ownership restrictions involves a strong national interest (keeping the production of agricultural products free from interferences) that is at odds with a local measure (the restriction on corporate ownership of farmland) and is designed to address a local concern (the protection of the family farm from inundation by corporate producers). In such instances, the challenging party would have to show uncontradicted evidence that the measure simply does not address the concern, or if it does, that its effect is slight and does not outweigh the national interest in keeping the production of agricultural products free from interference. In other words, the challenging party must demonstrate that the restriction on corporate ownership does not protect family farms.

The commerce clause is a better vehicle with which to pursue challenges to restrictions on corporate ownership of farms, especially if the challenging party can produce strong evidence that the professed concern about family farms is not being met under the current statute. Indeed, dormant commerce clause attacks accompanied by such evidence have fared much better than attacks based on equal protection which are analyzed under the rational relationship test.<sup>68</sup> Cases decided under dormant commerce clause principles receive a higher level of scrutiny than the deferential treatment commonly associated with the rational relationship tests for due process and equal protection violations.<sup>69</sup>

#### *D. The Cases*

Two recent cases have dealt squarely with the constitutionality of restrictions on corporate ownership of farmlands.<sup>70</sup> In *Omaha National Bank v. Spire*,<sup>71</sup> the Nebraska Supreme Court held that Nebraska's constitutional amendment barring nonfamily corporate ownership of farmlands did not violate the equal protection clause of the United States

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66. *Id.* at 775-79.

67. 434 U.S. 429 (1978).

68. See, e.g., *Raymond Transp.*, 434 U.S. 429; *Southern Pac.*, 325 U.S. 761.

69. See, e.g., *Raymond Transp.*, 434 U.S. 429; *Southern Pac.*, 325 U.S. 761.

70. A third case, *MSM Farms, Inc. v. Spire*, 927 F.2d 330 (8th Cir. 1991), was decided as this Article was being prepared for publication. In *MSM Farms*, the Eighth Circuit affirmed the judgment of the Federal District Court for the District of Nebraska, which upheld Nebraska's family farm amendment.

71. 223 Neb. 209, 389 N.W.2d 269 (1986).

Constitution.<sup>72</sup> In *State ex rel Webster v. Lehndorff Geneva, Inc.*,<sup>73</sup> the Missouri Supreme Court, using equal protection analysis, upheld Missouri's statute requiring a nonfamily corporate owner of farmland to divest itself within two years.<sup>74</sup>

On November 2, 1982, Nebraska voters approved Initiative 300 as an amendment to the Nebraska State Constitution.<sup>75</sup> Nebraska is currently the only state having such a constitutional provision restricting corporate ownership of farmlands.<sup>76</sup> Initiative 300, appearing in Article XII, section 8 of the Nebraska Constitution reads in pertinent part:

Sec. 8(1) No corporation or syndicate shall acquire, or otherwise obtain an interest, whether legal, beneficial, or otherwise, in any title to real estate used for farming or ranching in this state, or engage in farming or ranching.

\* \* \*

These restrictions shall *not* apply to :

(A) *A family farm corporation.*

\* \* \*

(D) Agricultural land, which as of the effective date of this Act, is being farmed or ranched, or which is owned or leased, or in which there is a legal or beneficial interest in title directly or indirectly owned, acquired, or obtained by a corporation or syndicate, so long as such land or other interest in title shall be held in continuous ownership or under continuous lease by the same such corporation or syndicate, and including such additional ownership or leasehold as is reasonably necessary to meet requirements of pollution control regulations.<sup>77</sup>

As revealed by this quotation, the amendment reads very much like a statute.<sup>78</sup> The effect of the "family farm amendment" is to prohibit new buying of agricultural land by nonfamily farm corporations. No nonfamily farm corporations currently owning agricultural land are required to divest themselves of that land.<sup>79</sup> The *Omaha National Bank*

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72. *Id.* at 232, 389 N.W.2d at 283.

73. 744 S.W.2d 801 (Mo. 1988).

74. *Id.* at 805-06.

75. Note, *An Equal Protection Analysis of the Classifications in Initiative 300: The Family Farm Amendment to the Constitution of the State of Nebraska*, 62 NEB. L. REV. 770, 771 (1983).

76. *Id.* at 771.

77. NEB. CONST. art. XII, § 8 (emphasis added).

78. Part of the complainant's argument in *Omaha Nat'l Bank* was that the amendment was in fact an improperly adopted statute, but this argument was unsuccessful. *Omaha Nat'l Bank*, 389 N.W.2d at 276.

79. See NEB. CONST. art XII, § 8.

case arose when Omaha National Bank brought an action in district court challenging the validity of the family farm amendment. Omaha National wished to continue its trust business, which often entailed owning and operating farmland in Nebraska.<sup>80</sup>

The only constitutional challenge made against the family farm amendment in *Omaha National Bank* was that it violated the equal protection clause of the United States Constitution.<sup>81</sup> Quoting *City of New Orleans v. Dukes*,<sup>82</sup> the Nebraska Supreme Court quickly dismissed the equal protection challenge: “When a local economic regulation is challenged solely as violating the Equal Protection Clause, this Court consistently defers to legislative determinations as to the desirability of particular statutory discriminations.”<sup>83</sup> The court further reasoned that because a state constitutional provision was being challenged, rather than merely a statute, the United States Supreme Court “would even more readily defer to the state constitutional determination as to the desirability of particular constitutional discriminations.”<sup>84</sup> Finally, the court relied on *Asbury Hospital*,<sup>85</sup> and without even conducting a rational relationship test, held that the family farm amendment did not violate the equal protection clause of the United States Constitution.<sup>86</sup> No evidence of any kind was offered by Omaha National in an attempt to show the irrationality of the amendment. When the bank’s lackluster attempt at challenging the amendment is considered with the deferential status afforded under the rational relationship test from United States Supreme Court equal protection doctrine already discussed, it is not surprising that the Nebraska Supreme Court ruled as it did.

In *Lehndorff*, a corporation fought Missouri’s attempts to force a divestiture of the corporation’s farm lands as required by Missouri statute.<sup>87</sup> As in *Omaha National Bank*, the corporation’s main defense was that its equal protection rights were being abridged.<sup>88</sup> Stating that

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80. *Omaha Nat'l Bank*, 389 N.W.2d at 272.

81. *Id.* at 272, 282.

82. 427 U.S. 297, 303 (1976).

83. *Omaha Nat'l Bank*, 389 N.W.2d at 282.

84. *Id.* The Nebraska Supreme Court cited no authority for this proposition. The logic appears to be that a constitutional amendment is more rationally based than a statute merely because it is a constitutional amendment.

85. 326 U.S. 207 (1945).

86. *Omaha Nat'l Bank*, 389 N.W.2d at 283.

87. *Lehndorff*, 744 S.W.2d at 803-04. The statute reads in pertinent part: “After September 28, 1975, no corporation not already engaged in farming shall engage in farming; nor shall any corporation, directly or indirectly, acquire, or otherwise obtain an interest, whether legal, beneficial or otherwise, in any title to agricultural land in this state . . . .” Mo. ANN. STAT. § 350.015 (Vernon Supp. 1990).

88. *Lehndorff*, 744 S.W.2d at 805.

the legitimate governmental interest involved was the protection of traditional farming entities from nonfamily corporations, the *Lehndorff* court found a rational relationship between the statute and its purpose.<sup>89</sup> The court stated, "The statute is rationally related to a legitimate state interest in that it prevents the aggregation of farmland in large corporations to the competitive exclusion of traditional [farm operators]."<sup>90</sup> Again, no attempt was made to demonstrate that the statute did not protect the traditional farm operator.

### *E. A Method of Attack*

An examination of Supreme Court doctrine and statistical data regarding Nebraska farmlands indicates that Omaha National could have made a stronger case. By limiting its case to an equal protection challenge, Omaha National needlessly subjected itself to the deferential rational relationship test. Omaha National did little to show that the classification prohibiting corporate ownership of farms in Nebraska was irrational. Omaha National should have based its claims on equal protection and commerce clause grounds.

The cases announcing the rational relationship test for equal protection violations indicate that if a local economic regulation is challenged on more than equal protection grounds, a court may not give the legislative determination the great deference of the rational relationship test. As the court stated in *City of New Orleans*, "When local economic regulation is challenged *solely* as violating the Equal Protection Clause, this Court consistently defers to legislative determinations as to the desirability of particular statutory discriminations."<sup>91</sup> The Supreme Court seems to be saying that it will not grant such great deference if the equal protection challenge is coupled with another constitutional argument.<sup>92</sup>

If Omaha National had succeeded in invoking a higher level of scrutiny than the rational relationship test, which is a very deferential

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89. *Id.* at 805-07.

90. *Id.* at 806.

91. *City of New Orleans*, 427 U.S. at 303 (emphasis added). Note that this was the very quote relied upon by the Nebraska Supreme Court in dismissing Omaha National's equal protection argument.

92. Although the plaintiff in *MSM Farms*, *supra* note 70, challenged Nebraska's family farm amendment on due process and equal protection grounds, 927 F.2d at 331, there appears to have been no attempt to force a less deferential analysis based upon the language of *City of New Orleans*, 427 U.S. at 303. As a result, the Eighth Circuit gave great deference to the amendment, although arguably a more pointed attempt to show irrationality was made than was made in *Omaha Nat'l Bank. MSM Farms*, 927 F.2d at 331. No commerce clause argument was made in *MSM Farms*.

standard of review when corporate ownership restrictions are involved, statistical data might have been enough to show that the Nebraska amendment is irrational. In other words, a dormant commerce clause argument coupled with the equal protection argument might be enough to take the case beyond the deferential rational relationship test and defeat the family farm amendment.<sup>93</sup>

Saving the family farm was the theme of the initiative campaign supporting Nebraska's family farm amendment.<sup>94</sup> But did Nebraska's family farms need saving? If so, did they need saving from corporate farms? A glance at some statistics shows that the answer to these questions is "no"!

In 1978, nonfamily corporations held only one-half of one percent (.5%) of Nebraska's 46,113,973 acres of farmland.<sup>95</sup> By 1982, in the years just prior to adoption of Nebraska's family farm amendment, that percentage had *dropped* to four-tenths of one percent (.4%) of Nebraska's 44,961,371 acres of farmland.<sup>96</sup> It is true that the number of nonfamily corporate farms in Nebraska increased from 205 to 281 during this time, but the *total* number of acres farmed by these corporations dropped by nearly one-fourth during the same time.<sup>97</sup> In other words, the number of nonfamily corporate farms was increasing, but the amount of Nebraska land farmed by these corporations was decreasing even before the family farm amendment was adopted. From 1978 to 1987, the amount of farmland held by nonfamily corporations in the United States remained virtually unchanged at one and one-half percent (1.5%) of all farmland.<sup>98</sup>

The relative absence of nonfamily corporate farms in Nebraska makes a strong case for the irrationality of the family farm amendment under the equal protection doctrine. The amount of land in Nebraska farmed by nonfamily corporations was declining even prior to the adoption of the family farm amendment.<sup>99</sup> There was not even a nationwide increase in the number of nonfamily corporate farms prior to (or since) adoption

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93. If the message of *City of New Orleans* is applied literally, such a two-pronged argument will be more successful than if the case is brought under equal protection or dormant commerce clause principles separately — even if the same data are used in support of the challenge in each case.

94. Note, *supra* note 75.

95. U.S. DEPT. OF COMM., BUR. OF THE CENSUS, 1978 CENSUS OF AG., STATE DATA: NEBRASKA, vol. 1, pt. 27, table 5, at 3.

96. U.S. DEPT. OF COMM., BUR. OF THE CENSUS, 1982 CENSUS OF AG., STATE DATA: NEBRASKA, vol. 1, pt. 27, table 5, at 4.

97. *Id.*

98. U.S. DEPT. OF COMM., BUR. OF THE CENSUS, CENSUS OF AG., UNITED STATES, 1978, vol. 1, pt. 51, table 5, at 3; 1982, vol. 1, pt. 51, table 5, at 4; 1987 vol. 1, pt. 51, table 20, at 16.

99. See *supra* notes 96-97.

of the amendment.<sup>100</sup> An equal protection argument, coupled with a commerce clause claim, might be enough to move the Court to abandon its strict deference for the Nebraska amendment and view it under a rational relationship test "with teeth."<sup>101</sup>

The balancing test announced in *Southern Pacific* coupled with the data mentioned above makes a strong case for invalidating the amendment under dormant commerce clause grounds. Omaha National should have made such a challenge on equal protection *and* commerce clause grounds and forced the Nebraska Supreme Court to at least examine the family farm amendment in more than a cursory fashion.

### III. CONCLUSION

Restrictions on corporate ownership of farmlands have existed throughout the twentieth century. Challenges to these restrictions based on due process and equal protection grounds routinely have failed. Therefore, an innovative challenger should combine equal protection and dormant commerce clause doctrines to shape a persuasive argument that should be worthy of serious consideration.

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100. *See supra* note 98.

101. Such a rational relationship test "with teeth" seems, as indicated above, to have been contemplated by the Supreme Court when it announced its deference in cases brought *solely* under equal protection grounds and did *not* state such deference would be granted in *all* equal protection cases. *City of New Orleans*, 427 U.S. 297.

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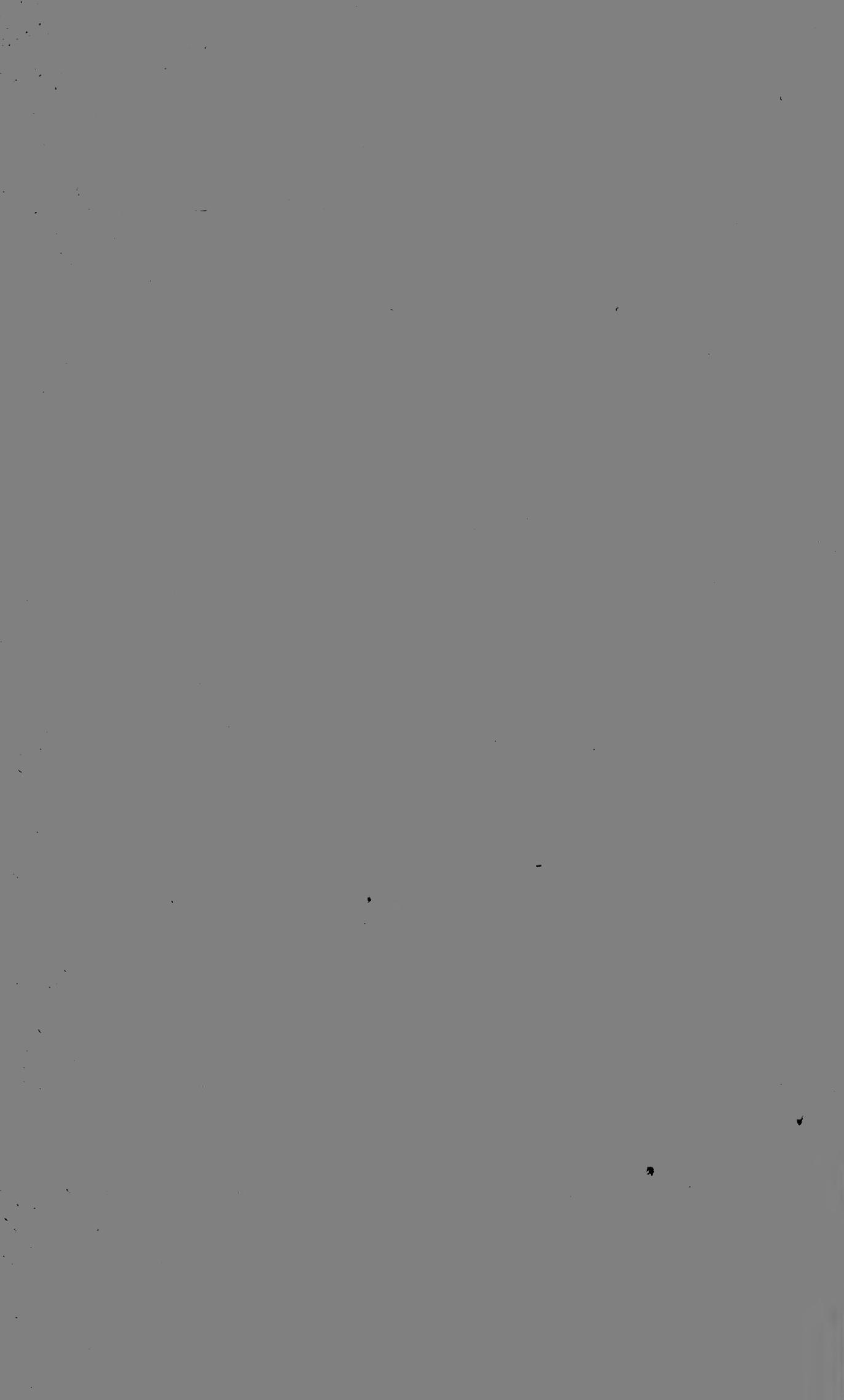
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